

Material 3

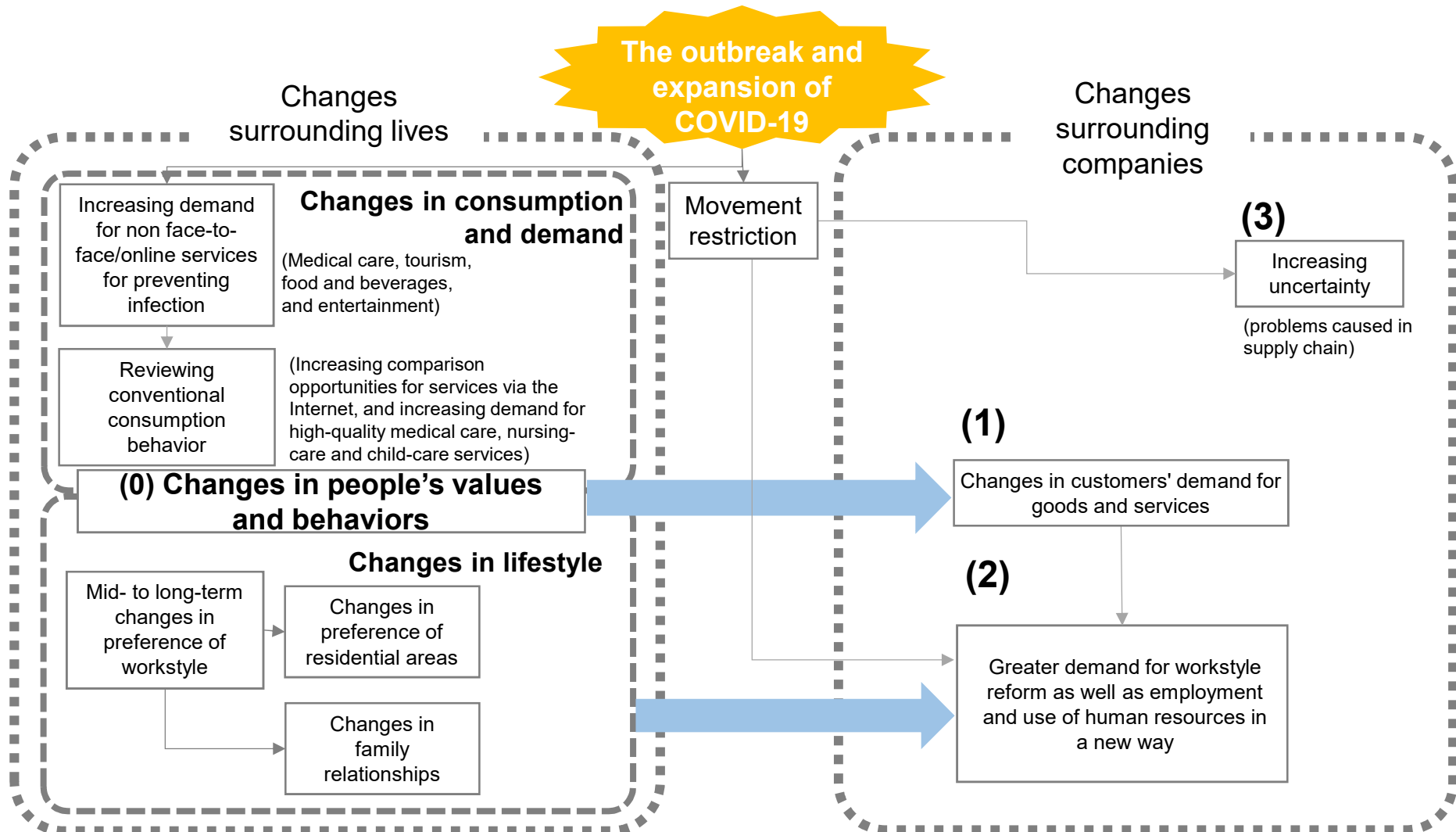
Provisional
Translation

Economic and social changes and challenges in Corporate Governance after COVID-19

October 20. 2020
Financial Services Agency

Changes in socio-economic structure after COVID-19 (1)

- ❑ The COVID-19 crisis causes new changes in people's lives. As for companies, some changes are caused by the COVID-19 crisis, while some changes are accelerated by the COVID-19 crisis.



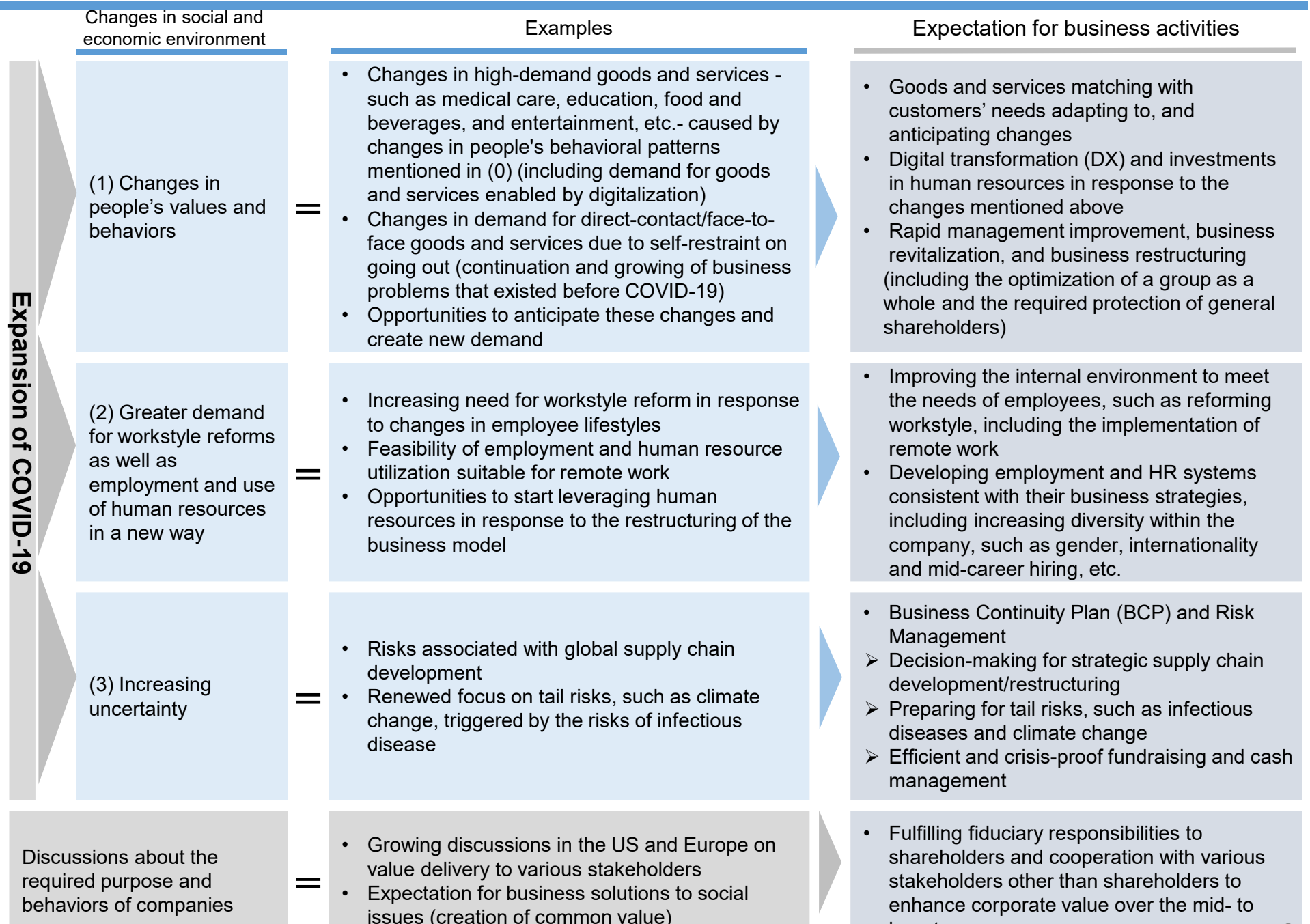
(*) Compiled by JFSA based on dialogues with companies, investors, and experts conducted after March 2020 in JFSA, the 42nd Council on Investments for the Future, dialogues, and results of surveys on the society post-COVID-19 conducted by CAO and private-sector research companies (see Reference 1).

Changes in socio-economic structure after COVID-19 (2)

Expansion of COVID-19	Changes surrounding lives	(0) Changes in people's values and behaviors	=	<ul style="list-style-type: none"> • Changes in consumption and demands <ul style="list-style-type: none"> ➢ Increasing demand for non-face-to-face/online services for preventing infection ➢ Increasing comparison opportunities for services via the Internet and reviewing conventional consumption behavior with movement restriction ➢ Increasing demand for high-quality medical care, nursing-care and child-care services
			=	<ul style="list-style-type: none"> • Changes in lifestyle <ul style="list-style-type: none"> ➢ Reconsidering workstyle including remote work, second jobs and job changes ➢ Changes in lifestyles including family relationships ➢ Changes in preference of residential areas (Higher interest in moving to the countryside and suburbs (remote work))
	Changes surrounding companies	(1) Changes in customers' demand for goods and services	=	<ul style="list-style-type: none"> • Changes in high-demand goods and services - such as medical care, education, food and beverages, and entertainment, etc.- caused by changes in people's behavioral patterns mentioned in (0) (including demand for goods and services enabled by digitalization) • Changes in demand for face-to-face goods and services due to self-restraint on going out (continuation and growing of business problems that existed before COVID-19) • Opportunities to anticipate changes in people's behaviors and create new demand and businesses
		(2) Greater demand for workstyle reforms as well as employment and use of human resources in a new way	=	<ul style="list-style-type: none"> • Increasing need for workstyle reform in response to changes in employee lifestyles • Feasibility of employment and human resource utilization suitable for remote work • Opportunities to start leveraging human resources in response to the structuring of the business model
		(3) Increasing uncertainty	=	<ul style="list-style-type: none"> • Risks associated with global supply chain development • Renewed focus on tail risks, such as climate change, triggered by the risks of infectious disease
Discussions about the required purpose and behaviors of companies		=	<ul style="list-style-type: none"> • Growing discussions in the US and Europe on value delivery to various stakeholders • Expectation for business solutions to social issues (creation of common value) 	

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Changes in socio-economic structure after COVID-19 (3)



Changes in socio-economic structure after COVID-19 (4) (interviews with institutional investors and companies)

	Changes that investors expect companies to make	Companies' approach and responses (examples)
Business Strategy	<ul style="list-style-type: none"> • Appointment of directors with necessary skills who back up management's prompt and decisive decision-making • Appropriate involvement of independent directors as COVID-19 requires reassessment of the business model, because change is difficult to achieve by internal personnel alone 	<ul style="list-style-type: none"> • Examining how to restructure business portfolios in light of the changes in demand structure after COVID-19 • Need to reexamine the future way of business because face-to-face/direct-contact services have been our strength
Digital Transformation (DX)	<ul style="list-style-type: none"> • Transformation of the business process itself through DX, rather than introducing DX while maintaining existing business processes 	<ul style="list-style-type: none"> • Digitalization requires action to establish new business models • Preparation was insufficient in terms of remote management systems and IT systems in the event of a contingency
Sustainability /Diversity	<ul style="list-style-type: none"> • Initiatives in substance rather than in form, not only regarding climate change but also sustainability issues as a whole • Diversity in backgrounds, not only gender but also nationality 	<ul style="list-style-type: none"> • Examining how companies with many business sites and partners should implement "Social" initiatives, including their supply chains • Continuing to work on the E of ESG
Financial Strategy	<ul style="list-style-type: none"> • Securing and improving companies' ability to generate future cash and the recognition of the meaning of holding cash during the COVID-19 pandemic 	<ul style="list-style-type: none"> • Increasing our cash on hand based on the impact of COVID-19 • Cash generated by cost reduction and other measures must be utilized as a source of funds for growth

(Note) JFSA conducted interviews with institutional investors and companies about "Governance to focus on under COVID-19" on May-September 2020

Subjects to be discussed at the 20th Council

□ Challenges of Corporate Governance for Post-COVID Transformation of Companies

- For companies to achieve new growth, each company must recognize the challenges and get ahead of the changes. To do so, it is important for companies to make transparent, fair, prompt and decisive decisions and implement them based on a corporate mission and vision of transformation shared with stakeholders, including shareholders, customers, employees, and communities.
 - In the previous Council meetings, the following issues have been raised as corporate governance issues.
 - Businesses with a recognition of their cost of capital (such as holding cash, cross-shareholdings)
 - Board effectiveness (such as improvement in quality and quantity of independent directors, diversity)
 - Mid- to long-term sustainability (such as sustainability, diversity of managerial positions)
 - Ensuring confidence in audits (such as the establishment of processes where the internal audit department directly reports to the managers and the board)
 - Group Governance (such as group management, protecting general shareholders of listed subsidiaries)
- ⇒ Looking ahead to the post-COVID economy and society, how should issues, such as additional new issues and changes in priorities, be reviewed?

□ Others

- ⇒ What other points regarding corporate governance should be discussed in the future?

(Reference) JFSA priorities for July 2020-June 2021 (Excerpt) (1)
(Published on August 31, 2020)

2. Make the Japanese financial and capital market more sophisticated and attractive (Excerpt)

(3) Reform corporate governance and enhance disclosures

For companies to lead non-linear changes in the economy, society and industrial structure and achieve renewed growth, it is imperative for them to make transparent, fair, prompt and decisive decisions and implement them based on a corporate mission and vision of transformation shared with stakeholders, including shareholders, customers, employees, and communities. In this fiscal year, we will, together with Tokyo Stock Exchange, review the Corporate Governance Code again, following the review of FY2017. In doing so, we will consider **corporate governance that would be adequate for helping companies lead reforms towards building a better post-COVID socio-economic structure**. In particular, **we will consider the way of constructive dialogues between investors and companies** as to:

- How companies should **approach digital transformation, supply-chain reforms and workstyle reforms**; and
- How they should **incorporate them into sustainable business models**.

(Reference) JFSA priorities for July 2020-June 2021 (Excerpt) (2)
(Published on August 31, 2020)

Appendix

2. Make the Japanese financial and capital market more sophisticated and attractive(Excerpt)

(3)Reform corporate governance and enhance disclosures

● Reform corporate governance

[Work plan for July 2020-June 2021]

The following subjects will be discussed in the Council meetings for the review of Japan's Corporate Governance Code.

- **the way of constructive dialogues between investors and companies for helping companies lead reforms towards building a better post-COVID socio-economic structure as to:**
 - ✓How companies should **approach digital transformation, supply-chains reforms and workstyle reforms**; and
 - ✓How they should **incorporate them into sustainable business models**.
- Aiming to further develop corporate value over the mid- to long-term, **promotion of business based on cost of capital**, such as the business portfolio strategies, **strengthening of group governance**, including the appropriate handling of listed subsidiaries, **ensuring of confidence in audits**, **consideration of mid- to long-term sustainability**, and **improvement of the quality of independent directors**
- **Higher level of governance required for companies listed on the “Prime Market”**

(Reference) "Japan's Corporate Governance Code [Final Proposal]" Preamble (1)

"The Council of Experts Concerning the Corporate Governance Code" March 5, 2015

Objectives of the Code [Final Proposal]

7. It is important that companies operate themselves with the full recognition of responsibilities to a range of stakeholders, starting with fiduciary responsibility to shareholders who have entrusted the management. [The Code seeks "growth-oriented governance"](#) by promoting timely and decisive decision-making based upon transparent and fair decision-making through the fulfillment of companies' accountability in relation to responsibilities to shareholders and stakeholders. The Code does not place excessive emphasis on avoiding and limiting risk or the prevention of corporate scandals. Rather, [its primary purpose is to stimulate healthy corporate entrepreneurship, support sustainable corporate growth and increase corporate value over the mid- to long-term.](#)

Recognizing the board's fiduciary responsibilities to shareholders and other stakeholder responsibilities, the Code includes language that calls for a certain measure of corporate self-discipline. It would not be appropriate, however, to view them as limits on companies' business prerogatives and activities. Indeed, quite the opposite: without appropriately functioning corporate governance, the reasonableness of management's decision-making processes cannot be secured. In such a case, the management may become risk-avoiding due to concerns that their responsibility with respect to business decisions may be put in question. Such a situation would significantly restrict decisive decision-making and companies' business activities. [By calling for appropriate corporate governance disciplines at Japanese companies, the Code aims to have the management free from such restrictions and establish an environment where healthy entrepreneurship can flourish and where the management's capabilities can be given full force.](#)

8. Given the concerns regularly perceived about the growth of short-term investment activities in capital markets, it is hoped that the Code will also have the effect of promoting mid- to long-term investing. [Market participants who have the strongest expectations for the improvement of corporate governance are usually shareholders with mid- to long-term holdings, and they usually wait until the improvements of corporate governance are achieved. Notwithstanding recent concerns over the growth of short-termism in the market place, such shareholders have the potential to become important partners for companies.](#) The Code asks companies to examine whether there are issues in their corporate governance in light of the aim and spirit of the principles of the Code, and take self-motivated actions in response to those issues. Such efforts by companies will make possible further corporate governance improvements, supported by purposeful dialogue with shareholders (institutional investors) based on Japan's Stewardship Code. In this sense, [the Code and Japan's Stewardship Code are "the two wheels of a cart", and it is hoped that they will work appropriately and together so as to achieve effective corporate governance in Japan.](#)

(Reference) ”Japan’s Corporate Governance Code [Final Proposal]” Preamble (2)

“The Council of Experts Concerning the Corporate Governance Code” March 5, 2015

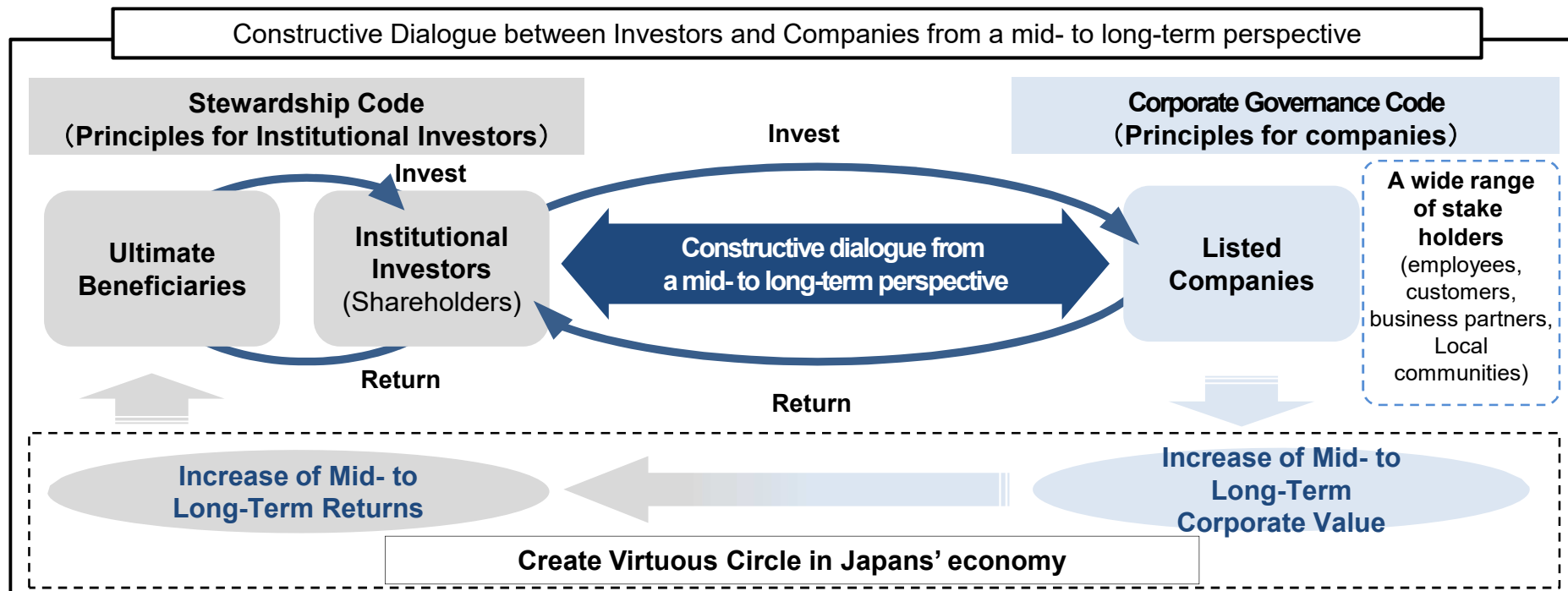
“Principles-Based Approach” and “Comply-or-Explain Approach”

9. The Code specifies General Principles, Principles and Supplementary Principles. The manner of their implementation may vary depending on industry, company size, business characteristics, company organization and the environment surrounding the company. [The Code’s principles should be applied in accordance with each company’s particular situation.](#)
10. Given the above, the Code does not adopt a rule-based approach, in which the actions to be taken by companies are specified in detail. Rather, [it adopts a principles-based approach so as to achieve effective corporate governance in accordance with each company’s particular situation.](#) This principles-based approach has already been adopted in Japan’s Stewardship Code. The significance of this approach is found in having parties confirm and share the aim and spirit of the principles and review their activities against the aim and spirit, not against the literal wording of the principles, even where the principles may look abstract and broad on the surface. For this reason, the terminology used in the Code is not strictly defined as is the case with laws and regulations. It is anticipated that companies that are accountable to shareholders and other stakeholders will apply appropriate interpretations of the terminology in accordance with the aim and spirit of the Code. 5 Shareholders and other stakeholders are also expected to fully understand the significance of this principles-based approach in their dialogue with companies.
11. Moreover, unlike laws and regulations the Code is not legally binding. [The approach it adopts for implementation is “comply or explain” \(either comply with a principle or, if not, explain the reasons why not to do so\).](#) In other words, the Code assumes that if a company finds specific principles (General Principles, Principles and Supplementary Principles) inappropriate to comply with in view of their individual circumstances, they need not be complied with, provided that the company explains fully the reasons why it does not comply.

(Reference) Efforts to Deepen Corporate Governance Reform

Efforts to Deepen Corporate Governance Reform

- ❑ As part of Japan Revitalization Strategy under Prime Minister Abe's initiative,
 - **Stewardship Code** (established on February 2014, revised on May 2017, second revised on March 2020)
 - ⇒ promotes **institutional investors (pension funds and the asset managers, to which pension funds outsource their asset management activities)** to improve and fostering the **investee companies' sustainable growth** through **constructive engagement**.
 - **Corporate Governance Code** (established on June 2015, revised on June 2018)
 - ⇒ promotes **listed companies** to **enhance mid- to long-term earnings power**, under effective business strategies, with **appropriate cooperation with stakeholders (including shareholders, employees, customers, business partners, and local communities)**.



(Reference) Outline of Japan's Corporate Governance Code (Established on June 1, 2015 Revised on June 1, 2018)

- The Corporate Governance Code promotes **listed companies** to **enhance mid- to long-term earnings power**, under effective business strategies, with **appropriate cooperation with stakeholders (including shareholders, employees, customers, business partners and local communities)**.

Framework

The Code

- is part of Securities Listing Regulations by TSE, which obligate listed companies to fulfill “comply or explain”.
- adopts a “**principles-based approach**” and the “**comply or explain approach**”.

Principles

1. Companies should fully secure the **rights and equal treatment** of shareholders.
ex : Disclosing a policy of **cross-shareholdings** / Explanation of its **objective and rationale** based on examination of economic rationale
2. Companies should **cooperate with stakeholders** including employees, customers, business partners and local communities.
3. Companies should appropriately conduct statutory disclosure and also **provide accurate & useful information** beyond that required by law.
4. To promote sustainable corporate growth and enhance earnings power & capital efficiency, the board should appropriately fulfill its roles and responsibilities, including **setting the broad direction of corporate strategy**, carrying out **effective oversight of directors & the management**.
ex : **Appointment of at least 2 independent directors** who are able to contribute constructive discussions
5. Companies should engage in **constructive dialogue** with shareholders in order to contribute to sustainable growth.