

Material 1

Provisional  
Translation

# Comments in the 20th Follow-up Council (Summary)

November 18, 2020  
Financial Services Agency

# Comments in the 20th Follow-up Council

## -Challenges of Corporate Governance for Corporate Reform after COVID-19-

General Discussion

Board

Awareness of  
Capital Cost, etc.

Sustainability

Ensuring Confidence  
in Audits

Group Governance

Others

### [Corporate Governance after COVID-19]

#### (Accelerating our ability to respond to change)

- Since the outbreak of COVID-19, change is accelerating and **the response to change needs to be accelerated**. It is necessary to correct companies' failure to act or procrastination
- Companies need to survive a crisis, and even launch restructuring: they need to **aggressively take risks to make it a growth opportunity**. **A governance system and strong leadership of top management** are increasingly becoming critical. Solid operating profitability and a strong financial foundation will lead directly to resilience
- We are entering an era that puts companies to a harsh test of **their abilities to achieve corporate transformation (CX) that fundamentally and uninterruptedly transforms their forms centering on decision-making abilities/systems**.
- From the perspective of the post-COVID-19 era, it is important to **enhance outcomes from the existing Code**.
- It is true that **transformations, which had been called for before COVID-19, have accelerated, and preexisting management risks have been revealed**. However, **important issues of corporate governance have not really changed**.

#### (DX (Digital Transformation))

- It is important for companies to **disclose** such information as **their corporate strategies about the digitalization** from the mid- to long-term perspectives.
- **It is important to have in place a DX governance system at the management level** that the use of data and AI does not damage the corporate philosophy.
- **Virtual board meetings** should also be considered.
- DX will not directly cause an increase in corporate value. Rather **companies need to consider how they can take advantage of and embrace DX for increasing the productivity**.
- DX does not mean a mere introduction of IT, but involves **a change in ways of thinking, and the important thing is restructuring starting with the digital transformation**.

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### [Corporate Governance after COVID-19]

#### (Other COVID-19 -related issues)

- In the era of uncertainty, one of the primary concerns for companies is [risk management](#).
- During times of natural disasters and infection, risk management, including BCP, is critical.
- [Human rights issues associated with the supply chain](#) are also important.
- In view of the impacts of cyberattacks on companies, it is important to [ensure cyber security](#).
- Responding to [increasing geopolitical risks](#) is also an important issue.
- In terms of expectations for corporate management, it is [important to challenge problems for which there is no right answer and to properly explain and take responsibility for the results](#). If we only work on problems for which there is a right answer, we will soon find ourselves in a position of excessive competition.
- Is the fixed, pre-determined tenure suitable for business innovation? In order for companies to undertake various transformations in the future, [the board's approach to the terms of office](#) would be a relevant point to be discussed.
- It is important to consider [how to respond to the corporate strategies and changes in employment and work styles](#).

#### [Stakeholder theory]

- While the so-called multi-stakeholder idea is a new concept that is attracting a lot of attention, [the Preamble of Japan's Code already referred to the significance of such a concept, including the need for a balance](#). In Japan, there [have been cases where the concept of stakeholder idea has been conveniently used](#), such as dividends can be reduced when companies place priority on ensuring job security, and I believe there were dividend cuts that took advantage of COVID-19.
- [In Japan's Corporate Governance Code, certain progress has been made about discussions in the US and Europe on value delivery to diverse stakeholders](#). However, there certainly is a social concern that DX might steal jobs from people, or expand social disparities. Therefore, I think we should refer to discussions in the US and Europe, and [revise the Governance Code by including supplemental descriptions about points to be corrected](#).
- [Strong earnings power also supports ESG/SDG management](#). An absolute requirement for companies to contribute to social value is strong and sustainable earnings power. In the first place, [Japan's Corporate Governance Code does not stand on the shareholder value supremacy](#). Instead, its basic philosophy is sustainable increase in corporate value for all stakeholders.

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### [Others]

- The Council is expected to discuss corporate governance – decision-making and oversight functions of the board. We should not go into detail about each change, for example, changes in practices of business execution. Instead, it would be better if we had discussions from a broader perspective, focusing mainly on such topics as how the board looks at such issues as a whole and makes decisions on them, and how the board engages in oversight activities.
- More in-depth dialogue is required concerning mid- to long-term strategies, risk strategies, and risk allocation strategies of the companies.
- As for the evaluation of the current situations, evaluations of the two Codes would fall into two types: one would be such a positive evaluation as “slow but steady progress in creating positive impact,” and another would be such a negative evaluation as “frustratingly slow.” Reasons for concurrently receiving these two different evaluations are differences in companies’ responses to the Codes. The positioning of listed companies is a very important topic, and it is also an issue related to the restructuring of TSE markets.
- It is important to return to the starting line, and it is essential to have deeper discussions again on such issues as cost of capital, the board effectiveness, mid- to long-term sustainability, confidence in audits, and group governance.
- Looking at the investment chain, the starting point for creating national wealth is that companies generate a solid return. Constructive dialogue is held for returns from companies.
- What can be done in order to encourage investors to provide risk money to Japanese companies from the long-term perspective? We need to readdress this issue by using objective evidence from the viewpoint of overseas investors.
- Some sort of evaluation about the Corporate Governance Code introduced in 2015 might be needed somewhere.

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### [Board Effectiveness]

#### (Composition of the Board)

- The number of expected independent directors should be set considering the fact that [approximately 60% of companies listed on TSE First Section have boards with at least one-third of directors being independent directors.](#)
- [The importance of the lead independent director is increasing.](#) The lead independent director is also important as a contact point of engagement.
- With regard to the composition of directors, at least one-third of them should be independent directors and, [desirably, the majority of them should be \(as in the case of listed subsidiaries\).](#)
- [The nomination committees](#) should be comprised of [people with diverse management experience, especially those who have management expertise that cannot be gained by the employees who have gained experience only in that company.](#)
- It is important to consider how to improve the quality of independent directors in a concrete way, [taking into account good practices overseas.](#) In doing so, [succession planning for independent directors](#) and [the scope of board evaluation](#) (including the nomination and remuneration committees and individual directors in the evaluation) will also be important.

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## [Board Effectiveness]

### (Other Board Effectiveness (e.g., Nomination Committee))

- The selection process should not be just an approval of a personnel proposal prepared by the executive body, but a generalized process to evaluate candidates and narrow down the list over a minimum of three years.
- It is unclear from the outside what the nomination and remuneration committees are discussing. Disclosure regarding the actual status of the nomination and remuneration committees should be enhanced.
- The nomination committee or the remuneration committee should monitor the succession and evaluation of not only the CEO, but also the entire management team. The role of independent directors is becoming more important than ever.
- The establishment of nomination (advisory) committee should be a de facto obligation. The majority of the committee should be independent directors.
- It is more important to establish an independent committee that is equivalent to the statutory nomination committee or statutory remuneration committee of company with a three-committee system in terms of independence, and to analyze and evaluate the effectiveness of such committees.
- The nomination committees should be comprised of people with diverse management experience, especially those who have management expertise that cannot be gained by the employees who have gained experience only in that company.

### (Others)

- While the responsibility of independent directors tends to be questioned, there is the responsibility of the board in the first place. Inside directors need to understand this, and if they cannot, they need to be asked to resign from their positions as inside directors.
- A board of directors needs to be able to exercise a healthy entrepreneurship, and have companies to move ahead of changes in the economic and social structure. In doing so, the cost of capital is again important as a measure.
- Dialogue between shareholders and directors including independent directors should be held more frequently. From the past experience, independent directors learn more when they engage with shareholders, and institutional investors' confidence in the company improves.

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### [Diversity of Directors and Candidates in companies]

- Japanese companies are becoming more and more multinational in their business activities. Meanwhile, management teams of most Japanese companies still consist of only Japanese people. [It will take time to promote women and foreign nationals to the management team internally. Japanese companies need to secure access to the global executive recruitment market and actual recruitment.](#)
- The reason for [making slow progress toward achieving diversity of human resources](#) is due to the [poor mobility of human resources](#) in Japan; therefore, the mobility of human resources is one of the themes to be considered in the future.
- [Diversity in the management team](#) is essential for DX and innovation. In order to achieve this, vision and values are necessary.
- Important things are the full use of [diversity & inclusion](#).
- [To facilitate changes, it is essential to ensure diversity.](#) This has likely resulted in the rule of a board with half or one-third of the board members being independent directors. As for the board composition, it is not right to set a numerical target first, since the objective is to ensure diversity.
- The society has been increasingly interested in the importance of diversity. This may be because the COVID-19 crisis renewed people's awareness of the fact that companies are exposed to many unforeseeable risks, and [in order for companies to be resilient, they need to ensure responsiveness to changes and creativity, and therefore, need to embrace diversity.](#) Embracing diversity is an important business strategy, and investors are required to become interested in such a factor.
- [To increase the number of women in managerial positions, it is desirable that more women are promoted to such positions within the companies, not only being appointed as external directors from outside.](#) For that purpose, companies need to disclose corporate attitudes concerning employment of female regular workers, flexible workstyles of employees, an environment where women can easily balance home life and work, and whether male employees can take childcare leave; and discuss such matters with investors.
- [Diversity has always been a source of innovation and new value creation in terms of business management, and an essential element of management strategy.](#) Companies will continue to work on promoting diversity, as a priority, from the perspective of the board effectiveness. Such corporate efforts will lead to the improvement of the competence of outside directors as well.
- [Ensuring diversity at the level of executive officers \(shikkoyakuin\) is important.](#) In order to undergo CX that responds to major changes of the era, [it is indispensable to ensure diversity \(in terms of gender, age, nationality, education, managerial background, etc.\) of candidates for future top management.](#) Diversity of core human resources precisely defines a company's competitiveness and transformation capability. The effectiveness of a succession plan also depends on the quality and diversity of human resources portfolio at the executive officer level who are candidates for future top management. [The Code should state this point, including numerical targets.](#)

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### [Diversity of Directors and Candidates in companies]

#### (Human resource development and improvement of the work environment)

- Human resources are an intangible asset and should be treated with respect. While there seems to be an argument for the multi-stakeholder idea in Japan, Japanese companies do not treat their employees well. Given the current state of affairs, with a much lower labor share and low salary levels, **it is important for companies to reward their employees as well.**
- To create a workplace that makes use of diverse human resources, it is not always sufficient to appoint managerial personnel and officers under the so-called seniority system. Instead, **companies should establish a framework in which each employee is fairly evaluated based on his/her abilities, skills, and performance, and is given positions, authorities, compensation, and opportunities that best fit his/her duties.** It is important to revise the Code under a principles-based approach so as to allow diverse employees to work in diverse ways and pursue diverse career development.
- It is not about providing and enforcing a new format in the name of “work style reforms.” Instead, it is necessary to look at **unique motivation** and circumstances of each individual more closely. Self-initiative and independence is important.
- **Measures on how to increase employee commitment and human capital investments** should be specified in the Code.
- **Disclosure around human capital management** is needed.
- How companies treat their employees and how they want the employees to work in the mid- to long-term is important. **Diversity of backgrounds and ways of thinking are important, not just formalities with regard to foreigners and women.** The stakeholder idea is acceptable, but **what is important would be to increase corporate value over the mid- to long-term.**



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### [Cost of Capital Awareness]

- Dividends should be determined by a board resolution. [Companies should decide on dividends based on the cost of capital](#), and then companies should disclose their dividend policy and growth strategies.
- According to a survey, [less than half of the management practices are conscious of cost of capital](#), so it is important how to incorporate the Code into the real business.

### [Review of Business Portfolio]

- While industrial portfolios have significantly changed in other countries, [Japan still relies on the traditional manufacturing industry, and earnings from digital platforming businesses are limited](#). It leads to the low net profit margin and the low ROE of Japanese companies, which is significantly behind that of the US and European companies. It is necessary to analyze the actual situation in this regard.
- It is necessary to re-evaluate and re-establish [a transformation of the business portfolio](#) more comprehensively.
- With the acceleration of DX, companies have another option besides selection and concentration, that is to adopt a strategy to focus on synergy among businesses and collaboration. In that case, companies need to be able to provide [a clear account on a path to increase corporate value by such specific combination of businesses](#).

### [Cash]

- Due to COVID-19, many companies are inclined to hold cash. In such an emergency situation, rich cash reserves held by Japanese companies made a positive contribution. However, such cash holdings should not be justified, because what is needed are [adequate and healthy financial strategies](#).
- There is no doubt that changes in the society will create new investment opportunities. Considering the level of cash and deposits held by Japanese companies, Japan is in a position to have a capacity to invest aggressively in the future, including investments in intangible assets and human resources. [Companies are tested about their abilities to earn and use profits](#).
- [The importance of cost of capital and cash flow of companies](#). As pointed out in "Lead and Disrupt," it is important both to narrow existing businesses down to profitable businesses (exploitation), and to make bold investments in exploring new areas (exploration) by utilizing operating cash flow from the adequate use of debt finance. The traditional view is that "If a company focuses only on short-term profit, it will not be able to make long-term investments, and therefore, lose growth potential." Instead, abundant operating cash flow is the source of corporate strength.

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- Human rights in the supply chain should be considered.
- While work styles are changing, we need to discuss the necessity of face-to-face discussions and what it is like to make corporate decisions online, because judgments on such matters will become increasingly important.
- During the COVID-19 pandemic, the engagement with the community will be the center of focus, engagement with essential workers, including healthcare and nursing care workers, in local communities.
- It is also very important to develop a resilient society/economy by focusing on the environment and society from the perspective of ESG.
- The establishment of sustainability committees should be encouraged. While such a committee tends to be established under the oversight body in European companies, the sustainability committee could be established under the executive function in our case.
- When the term “sustainability” is used, it tends to lead to discussions on ESG or environmental issues, but it is important to consider the sustainability of a companies themselves. There is a lot of emphasis on the disclosure of nonfinancial information, but this will lead to the future value of a company and its future sustainability. It is necessary to consider measures and concepts in the Governance Code that will push the sustainability of a company itself a little further.
- I agree with the CII’s view that “‘if ‘stakeholder governance’ and ‘sustainability’ become hiding places for poor management, or for stalling needed change, the economy more generally will lose out.”
- At board meetings and in dialogue between companies and investors, discussions on how a strategy concerning short- to mid-term business portfolios will be linked to increasing long-term corporate value in alignment with the SDGs are expected.
- Social factors are important as a key determinant of a company’s long-term financial health and sustainability. Companies should (1) ensure employee safety and welfare while meeting short-term liquidity requirements; (2) pursue a long-term view on social responsibility, fairness and sustainable value creation, and publicly defining a social purpose; (3) take a holistic and equitable approach to decisions on capital allocation to stakeholders; and (4) communicate comprehensively with all stakeholders.

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- As we have recently seen cases where kansayaku failed to perform their duties, it is necessary to **expect more from kansayaku, and further put spurs to them.**
- **The kansayaku board should be responsible for selecting kansayaku candidates, and the decision should be made upon consultation between the kansayaku board and the nomination committee.**
- It is inherently **desirable for kansayaku to be members of the nomination committee and other optional committees.** Kansayaku are more knowledgeable about internal affairs than independent directors are. Therefore, kansayaku can make use of their insights into governance, risk management, and internal control at such committee meetings.
- **Kansayaku should be required to participate in dialogues with investors.**
- With regard to **the third-party committee**, the roles of independent directors or outside kansayaku should be clearly defined as being involved in the selection of members of the committee, or checking the abilities, independence, and morality of the members and monitoring the adequacy of investigation expenses.

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## [Optimizing Group Management]

- It is important to discuss strategies for the entire group and internal control of [the entire group from the perspectives of securing efficient allocation of management resources](#) and allocation method to achieve the overall optimization, business portfolios, and formulation and implementation of the group-level business portfolio strategy.
- When parent and subsidiary companies have a close business relationship, conflict of interest may occur between the parent company and minority shareholders of the subsidiary company, which can lead to a dispute, thus damaging corporate values of both companies. When both parent and subsidiary companies need to undergo drastic CX, there is a risk where conflicts of interest attributable to their relationship occur, which will compromise their strategic freedom and promptness, thus reducing their CX capabilities. Parent subsidiary listing should not be allowed except for such transitional cases as one in the course of a spin-off of a growth business, and [the Code should state the controlling shareholder's obligations to protect the interest of minority shareholders \(fiduciary duty\), similar to a principle commonly used in the US and Germany.](#)

## [Protection of minority shareholders of subsidiary companies]

- [The protection of minority shareholders from controlling shareholders](#) is an important point.
- [High-risk type of conflicts of interest between controlling shareholders and minority shareholders, focusing on the decision-making process and disclosure.](#) Especially, we should review the Code in terms of such decision-making process, in consideration of the involvement of independent directors and minority shareholders in such types of conflicts.
- [It is important to eliminate adverse effects of the parent-subsidiary listing.](#) Currently, controlling shareholders have option rights over the controlled companies, so to speak, and are able to make the company a wholly-owned subsidiary at a time when they feel it is advantageous to do so or sell the shares of it, which often leaves minority shareholders at the mercy of the strategies of the controlling shareholders. [Companies should reorganize parent-subsidiary listings: they should formulate strategies as to whether they should hold 100 percent shares or zero percent, and disclose such strategies to the public.](#)

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### [General meeting of shareholders, etc.]

- The [electronification of general shareholders meetings, online general shareholder meetings and the enhancement of electronic disclosure will be required](#). We could consider the use of ICJ [Investor Communications Japan] for electronic voting.
- Looking at the recent COVID-19 situation, considering [a risk of concentration of AGMs next year and onward](#), we should thoroughly discuss [the possibility and significance of the virtual-only AGMs, not only hybrid AGMs](#).
- [The Annual Securities Report \(Yu-ho\) should be published prior to the AGM. Companies listed in TSE Prime Market should prepare English translated Yu-ho and Notice of AGM. Furthermore, companies should move their record dates to April and hold AGMs in July.](#)
- With regard to [hybrid or virtual-only AGMs](#), regulators are encouraged to ensure that [shareholder rights are not infringed](#) so as not to restrict their ability to hold companies accountable. Companies should consider publishing AGM information at least one month prior to the meeting, use video technology to allow for facial expression to be shown, ensure participants can ask questions or express opinions, as well as record and respond to all questions and promptly disclose such responses.
- This year, an increasing number of companies held hybrid AGMs. As a result, it became clear that they typically failed to [secure shareholder rights](#). It is essential to ensure the interactivity and instantaneousness during Q&A sessions as well as live streaming.

### [Quantification of corporate value, etc.]

- It is important to [quantify non-financial factors](#), including intangible assets, intellectual property, digital platform elements, and the degree of contribution to the environment.
- [The market cap or share price will be an extremely important element.](#)
- [We need to redefine corporate value in this review.](#) Corporate value could be defined in two ways: financial definition and non-financial definition. We need to consider how to measure non-financial corporate value from the financial viewpoint.

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### [The way the Code is applied (including a reform of market sections)]

- With the review of market classifications, there is a need for a renewed awareness of the global capital market. [The Prime Market](#) means running business in global competition, and [we need to be aware of global perspectives](#) (e.g., composition and qualifications of independent directors, establishment of nomination and remuneration committees, etc.). From an overseas investor's point of view, the listing of parent-subsidary listings and cross-shareholding may appear to abuse the market function. It would be good if we could incorporate these big ideas into each discussion.
- In Japan, the current Code adopts the principle-based approach, asking companies either to “comply or explain.” However, in other countries, some are moving towards “apply and explain” approach. In order to improve the effectiveness, we could discuss [principles themselves toward such a direction, and deepen the principles](#).
- Corporate management and stakeholders support [the principle-based approach](#), because each company can adapt its response depending on its specific circumstances.
- We should return to the principle-based approach. Since the introduction of the Code, ‘Comply or Explain’ has drawn attention. However, especially in case of providing explanations, [companies need to have an understanding of the underlying philosophy of principles](#) under the principle-based approach.

# Agenda Items

- In the future Follow-up Council, we will discuss the following items as corporate governance issues for the post-COVID-19 transformation.

Agenda Items	Detail
<b>Board effectiveness</b>	<ul style="list-style-type: none"> <li>• Improving the quality and quantity of independent directors</li> <li>• Diversity of directors and their candidates</li> <li>• Establishment and use of nomination committees and remuneration committees (e.g. independence) and enhancement of succession plans</li> <li>• Use of Board Evaluation</li> </ul>
<b>Management in light of the cost of capital</b>	<ul style="list-style-type: none"> <li>• Implementation of business portfolio strategy</li> <li>• Cash holdings and cross-shareholdings</li> <li>• The concept of corporate value</li> </ul>
<b>Ensuring confidence in audits</b>	<ul style="list-style-type: none"> <li>• Strengthening of kansayaku, internal audit departments, etc. (e.g., dual reporting lines, triple auditing, etc.)</li> <li>• Effective use of the whistleblower system</li> <li>• Risk-taking and internal control system, including proactive risk management on enterprise level</li> </ul>
<b>Group governance</b>	<ul style="list-style-type: none"> <li>• Optimal allocation of management resources and risk management in group management</li> <li>• Protection of minority shareholders from controlling shareholders</li> </ul>
<b>AGM</b>	<ul style="list-style-type: none"> <li>• Early provision of AGM materials, dispersion of the AGM schedule, disclosure in English, electronic voting, virtual shareholder meetings</li> </ul>
<b>Mid- to long-term sustainability</b>	<ul style="list-style-type: none"> <li>• Mid- to long-term sustainability including ESG factors</li> <li>• Diversity in management, etc.</li> </ul>
<b>Especially challenges of corporate governance for corporate reform after COVID-19</b>	<ul style="list-style-type: none"> <li>• Transformation of companies in the context of digital transformation</li> <li>• Developing and investing in human resources and improving the internal environment for sustainable growth</li> <li>• Risk management in response to increased uncertainty (e.g., infectious diseases, climate issues, human rights, data security)</li> </ul>

※In addition, there are other issues, such as the management of conflicts of interest between sponsor companies and corporate pension plans (“Second Revision of the Stewardship Code” [The Council of Experts on the Stewardship Code (FY2019), published March 24, 2020]).