

Material

Provisional translation

**Revisions of Japan's Corporate Governance Code and
Guidelines for Investor and Company Engagement
(Draft)**

**The Council of Experts Concerning the Follow-up of Japan's Stewardship Code
and Japan's Corporate Governance Code
March 31, 2021**

I . Introduction

Under the changing environments surrounding business firms triggered by the COVID-19 pandemic, all companies must recognize challenges and get ahead of the changes for their future growth. To do so, it is important for them to promptly address corporate governance issues, such as to make the board more effective, promote diversity in their core human resources, and pursue sustainability toward their continuous growth and increase of corporate value over the mid- to long-term.

In April 2022, the Tokyo Stock Exchange will shift to a new market segmentation. The Prime Market is expected to be a market attractive to both domestic and global investors, and global investors will be given good investment opportunities in Japan there. Therefore, it is important for companies listed on the Prime Market to advance efforts toward a higher level of corporate governance. It is also important for companies listed on other markets to make efforts to improve their corporate governance to achieve sustainable growth and increase corporate value over the mid- to long-term with the characteristics of each market in consideration.

In order to encourage companies to advance a higher level of governance, in December 2020, the Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code (the "Council") published Opinion Statement No.5 "Board Effectiveness and Ensuring Diversity in the Core Human Resources in Companies for Post-COVID Transformation of Companies" (the "Opinion Statement No.5"). After this publication, the Council discussed and considered issues, such as sustainability, group governance and ensuring confidence of audits. Subsequently, the Council recommended proposals to revise Japan's Corporate Governance Code (the "Code") under the "comply or explain" approach, adding to the contents of Opinion Statement (5) (Please see Appendix 1 for details). In order to further encourage constructive dialogue between companies and institutional investors, the Council has also proposed revisions to the Guidelines for Investor and Company Engagement (the "Guidelines") (Please see Appendix 2 for details; hereinafter referred to as "Revision Drafts" together with the revision draft of the Code.).

II . Recommended Revisions to the Code and the Guidelines

The Revision Drafts include issues such as, group governance, ensuring confidence of audits, and the general shareholder meeting, as well as board independence, ensuring diversity in the company's core human resources and managing sustainability related factors. The basic recommendations on the Revision Drafts are as follows.

1. Ensuring Board Independence

As described in Opinion Statement No.5, under non-linear changes in the business environment, the board is required to support and effectively oversee management's prompt and decisive risk-taking as well as making important decisions.

To do so, it is important for companies listed on the Prime Market, where investors could expect to find good investment opportunities in Japan, to appoint enough independent directors to account for at least one-third of the board. Further, if they consider necessary in light of their business environment and business characteristics, etc. companies should consider to appoint enough independent directors to form the majority of the board.

In addition, it is important to ensure that the board as a whole has the skills necessary in light of the mid- to long-term company direction and business strategy. To do so, it is important for companies to identify the skills, etc. that the board should have in light of their business strategies, and then disclose the combination of skills, etc. that each inside and outside director possesses in an appropriate form according to the business environment and business characteristics, etc. for example in the form of a so-called "skills matrix." It is also crucial to include independent directors with management experience* in other companies because independent directors are expected to play a more important role in ensuring that companies anticipate changes in the business environment and reflect them in their business strategies. It is important that these skills, etc. are actually utilized in the duties of each director for board effectiveness.

In addition, it is important to appoint individuals who are capable of fulfilling the role expected of them besides satisfying independence criteria. It is also important for independent directors to be well aware of the expected roles and fulfill them.

In addition, as the CEO plays a central role in management, the appointment and dismissal of the CEO is the most important strategic decision for a company. Based on the point, the existing version of the Code requires companies to establish independent advisory committees, such as a nomination committee and a remuneration committee. However, despite the fact that ensuring the independence of the committees is one of the important factors for it to fulfill its expected functions, it has been pointed out that it may not be sufficient at present, and that it is important to further enhance its independence in comparison with other countries.

Accordingly, from the perspective of making the board more effective, it is important for companies listed on the Prime Market to establish a nomination committee and a remuneration committee that are comprised of a majority of independent directors.

In addition, it is desirable that the nomination committee is involved in the nomination and succession planning of - not only the CEO- but also directors, and the remuneration committee should ensure the development of a

* These directors does not mean only those with the experience of CEO, etc.

remuneration system that is consistent with business strategy. However, it has been pointed out that, in many cases, disclosure is insufficient on what roles and powers such committees have been given and what activities they perform. In light of these comments, it is important to clarify the mandates and powers of the nomination committee and the remuneration committee to improve the transparency of the board related to nomination and remuneration.

With regard to CEOs and directors, it is important not only that appropriate processes are in place at the time of nomination but also that the effectiveness of the board, individual directors and board committees are periodically evaluated.

Further, from the viewpoint of absorbing management analysis and opinions from the perspective of capital providers and stimulating a healthy entrepreneurial spirit for sustainable growth, it is important for directors including independent directors to understand and recognize the perspective of institutional investors through dialogue. However, it has been pointed out that constructive dialogue with independent directors is not sufficiently advanced. In order to ensure appropriate response to any shareholder concerns by attendees of dialogue, it is important to take appropriate measures, such as appointing a lead independent director.

Furthermore, it is important to ensure the effectiveness of overseeing management by the board through the appointment of an independent director as the chairperson, if it is considered to be necessary in light of a company's governance structure. It is expected that this point will be further considered through dialogue with institutional investors.

2. Promoting Diversity in Core Human Resources

For a company to lead the non-linear changes brought about by the COVID-19 pandemic and achieve new growth, a diversity of perspectives and values is required, not only in the board, but also in management. Besides fully recognizing the business environment surrounding companies in Japan, it is very important to build a system to ensure diversity in terms of gender, internationality, work experience, age, etc. at the middle managerial level, which supports the top management and board, and to ensure that these core human resources gain experience and eventually are appointed as the top management and directors. The board is expected to promote and oversee such efforts in a proactive manner in order to ensure diversity.

Accordingly, it is important that companies should present their policies and voluntary measurable goals for ensuring diversity in core human resources, such as the promotion of women, foreign nationals and midcareer hires to middle managerial positions, as well as disclosing their status. Companies should also present their policies for human resource development and internal environment development to ensure diversity, as well as the status of their implementation. It is also important that companies disclose their policies for

human resource development and internal environment development to ensure diversity, as well as the status of their implementation.

3. Attention to Sustainability and ESG

With the aim of increasing corporate value over the mid- to long-term, it is becoming increasingly important to positively and proactively address factors related to sustainability (including environmental, social and governance factors), not only as a risk, but also as earning opportunities. In terms of sustainability, there has been a growing focus on environmental elements, and recently the importance of social elements, such as investment in human capital, has also been emphasized. It has also been pointed out that it is desirable to advance more effective efforts with regard to intellectual properties in addition to investment in human capital from the perspective of strengthening international competitiveness.

Based on these considerations, it is required for the Board to develop a basic policy for the company's sustainability initiatives in terms of increasing corporate value over the mid- to long-term, and to consider and promote such initiatives on a company-wide basis, including the development of an oversight system such as a committee on sustainability and engagement with stakeholders. Some sustainability related issues are common to all companies, while others may differ depending on the circumstances of each company. It is important for each company to accurately understand its own situation and decide on sustainability elements of most relevance to be addressed on a case-by-case basis, in order to ensure a substantive rather than a formulaic response to sustainability.

In addition, and in recognition that investments in human capital and the creation of intellectual property have a significant impact on corporate value when allocating management resources for sustainable corporate growth, it is necessary to effectively supervise the allocation of management resources such as investments in human capital and intellectual property to ensure their contribution to company's sustainable growth.

Further, from the perspective of promoting constructive engagement on sustainability between investors and companies, it is important to disclose information on sustainability. In particular, the Taskforce for Climate-related Financial Disclosures (TCFD) recommendations is currently an internationally well-established disclosure framework for climate change. In addition, the IFRS Foundation, the body that sets International Financial Reporting Standards (IFRS), is in the process of developing a unified disclosure framework for sustainability, including climate change, while taking into account the TCFD recommendations.

Japan is expected to actively participate in this initiative to develop a comparable and consistent disclosure framework for climate change. When the IFRS Foundation develops a unified framework for sustainability disclosure based on the TCFD recommendations, it is expected that the framework will be equivalent to the TCFD recommendations. Also, it will be important to provide

specific information on investments in human capital and intellectual property to increase corporate value over the mid- to long- term.

With respect to such investments toward the future, it is essential to ensure the implementation of sustainable management and investment strategies by securing sufficient operating cash flow to support the execution of investment strategies.

4. Other Individual Items

(1) Group Governance

With regard to group governance, it has been pointed out that it is important to develop governance systems to protect minority shareholders of listed subsidiaries, such as by strengthening their governance systems, in light of recent discussions on the nature of group-based management.

A controlling shareholder should respect the interests of the company and the common interests of shareholders, and should not treat minority shareholders unfairly. Accordingly, in companies with a controlling shareholder, it is required to protect minority shareholders through measures such as the realization of a higher level of independence in the composition of the board, or deliberations and reviews by an independent special committee for material transactions and actions that conflict with the interests of controlling shareholders and minority shareholders (e.g., direct transactions between a parent company and its subsidiary, business transfers or business adjustments between a parent company and its subsidiary, and a parent company squeezing out minority shareholders). It is also important for companies to take measures in order to ensure the protection of the common interests of the company and independence of the board from the controlling shareholder in terms of the ratio of independent directors and the mechanism for their appointment. In addition, it is desirable that not only companies with controlling shareholders but also companies that have a major shareholder having a similar level of control (quasi-controlling shareholders) will take measures based on the Revision Drafts.

(2) Ensuring Confidence in Audits, Internal Control and Risk Management

Ensuring confidence in audits is important as a basis for achieving mid- to long-term increase in corporate value. In particular, in “Recommended Directions for Further Promotion of Corporate Governance Reform” (Opinion Statement No. 4 of the Council of Experts Concerning the Follow-up of Japan’s Stewardship Code and Japan’s Corporate Governance Code” published in April 2019), it is pointed out that the internal audit department is under the control and supervision of the CEO in most companies, and that the oversight function of the department has not been fully performed in cases where senior management has been involved in dishonest practices.

In light of these points, it is important for companies to ensure coordination between the internal audit department, directors and *kansayaku* by establishing

processes where the internal audit department directly reports to the board, audit committees and the *kansayaku* board. In addition, in order to ensure the effectiveness of the operation of the whistle-blowing system, it is also important that the disclosure and explanation of the whistleblowing system and the results of operation related to whistle-blowing are easy to understand in order to ensure the effectiveness of the whistle-blowing system.

With regard to internal control and risk management, the board is required to develop an appropriate internal control and risk management system. In this context, there are comments to the importance of the perspective that the board should appropriately determine and assess the risks assumed by the company from a viewpoint of increasing corporate value. There are also comments to the importance of the board being more aware of internal control and risk management as governance issues and handling them. Further, for companies operating as a group, there are comments to the importance of making actions from the perspective of the group company level.

Therefore, it is important for the board to supervise the establishment and operation of effective internal control and enterprise risk management, including on the entire group basis. Considering the importance of such a system, it is also important to ensure that the necessary resources are allocated in the establishment and operation of the system.

Furthermore, in order to ensure the reliability of audits, it is important that *kansayaku* make appropriate judgments from an independent and objective standpoint. From this perspective, it is important that *kansayaku* are appointed through appropriate procedures, including the consent of the *kansayaku* board.

(3) General Shareholder Meetings Related Matters

In order to make the entire decision-making process at general shareholder meetings constructive and substantive, companies are required to take appropriate measures to ensure the exercise of shareholder rights, and to enhance the provision of information.

To this end, it is important for companies listed on the Prime Market to disclose necessary information in English and make available the Electronic Voting Platform.

It is also desirable that consideration be given to the early disclosure of materials for shareholder meeting electronically in a medium that is convenient for shareholders, and to the setting of the date of the general shareholder meeting and any associated dates in light of such factors as securing sufficient time for closing and auditing. In this regard, it is important to encourage companies that are considering changing their record dates to do so. In addition, it would contribute to constructive dialogue with investors if the results of the analysis of causes and the results of consideration of responses to company-proposed proposals that received a significant number of negative votes at a general shareholder meeting are explained in an easy-to-understand manner

during dialogue with institutional investors, and if annual securities reports are disclosed before the general shareholder meeting. Further, when holding a general shareholder meeting virtually from the perspective of ensuring opportunities for shareholders to attend and participate, it is important to ensure transparency and fairness besides giving consideration to the interests of shareholders in the operation of the meeting.

(4) Major Issues other than the Above

As the COVID-19 disaster accelerates changes in the environment surrounding companies and the increases uncertainty, it will be more necessary to allocate management resources, including the examination of business portfolio based on the cost of capital for each business segment.

Therefore, the board (or the board of the group headquarters in the case of a company with group management) is required to determine and review the basic policies regarding the business portfolio in a timely and appropriate manner, and to explain the policies and the status of reviews in specific and easy-to-understand manner in a way that will deepen shareholders' understanding. In addition, when companies with group management explain their approach and policies regarding group management, it is important to make such explanation specific and easy-to-understand.

While further reduction of cross-shareholdings is also an issue, enhanced disclosure of methods for examining the holding effects of cross shareholdings[†] would contribute to dialogue with institutional investors, and it is desirable to fully take into account the perspective of the common interests of shareholders in such examination, for example, through effective involvement of independent directors.

With regard to the relationship between pension fund beneficiaries and the pension fund sponsor, it is important that the sponsor avoids interfering with the investment decisions for the interests of the beneficiaries.

Further, given that *kansayaku*, as well as directors, have a fiduciary responsibility to shareholders, they should have a basic position to engage in dialogue with shareholders to the extent reasonable, taking into account their requests and interests, in order to contribute to the sustainable growth of the company and the increase of corporate value over the mid-to long-term.

III. Implementation of the Revision of the Code

In April 2022, the Tokyo Stock Exchange will put its new market segmentation in force. Among the principles and supplementary principles of the revised Code, there are items that apply to companies listed on the Prime Market, items that

[†] Cross-shareholdings include shares that are not directly held by a company but in practice are under the company's control, such as shares held in trust for retirement benefit trusts.

apply to companies listed on the Standard market, and items that apply to both of them following the new market segmentation.

Companies are expected to submit their corporate governance reports reflecting the revised Code by December this year at the latest. In addition, with respect to the principles that apply only to companies listed on the Prime Market, time may be needed for preparation, so that it is conceivable for companies to be asked to submit their corporate governance reports reflecting the revised principles in the timing soon after the conclusion of their general shareholder meetings that will take place after April 2022. The Tokyo Stock Exchange is expected to consider the more specific timing of the submission of the reports.

It is desirable that companies listed on other markets also take voluntary initiatives to improve their governance by using the Code items for companies listed on the Prime Market as a reference.

Furthermore, for companies listed on the Growth Market, where only the Code's general principles apply as a comply-or-explain norm, it is desirable that such companies take voluntary initiatives to improve their governance by using the Code's principles and supplementary principles as a reference, depending on their situations.

While the revision draft of the Code has been made bearing in mind the companies listed on the Tokyo Stock Exchange, other stock exchanges are expected to consider their version for their markets based on the revision draft, taking into account the characteristics of each relevant market.

IV. Conclusion

The Council anticipates that the Tokyo Stock Exchange will make revisions of the Code promptly, and the Financial Services Agency will make revisions of the Guidelines for Investor and Company Engagement, following the Revision Drafts.

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