28th Meeting of the Council of Experts Concerning the Follow-up of Japan’s Stewardship Code and Japan’s Corporate Governance Code

Material 5

Provisional translation

Reference Materials for the 28th Meeting of Council

April 19, 2023

金融庁
Financial Services Agency, the Japanese Government

Recap of the 27th Follow-up Meeting (May 16, 2022)

Empirical research on effects/impact of corporate governance reforms - summary

- Overseas, there has been an accumulation of empirical research on the conditions under which corporate performance is affected by corporate governance systems and shareholdings by institutional investors.
- On the other hand, the number of empirical studies covering the period after the implementation of Japan's corporate governance reforms is not yet large, and the research results vary, resulting in an undetermined evaluation of the reforms.

Implications from Empirical Research

Outside Directors

(Pre-reform research)
- **Appointment of outside directors boosts market valuation.**

(Post-reform research)
- **No statistically significant relation between the appointment of outside directors and corporate value**

Committees

Firms with nomination & remuneration committees have higher ROA growth rate.

Capital Policy

Reduction of surplus cash and deposits by companies with poor capital efficiency boosts market valuation.

Cross-shareholdings

- **The higher the number of cross-shareholdings, the lower the profit margin, and the profit margin improves by selling them.**
- **Unwinding cross-shareholdings increases share repurchases and dividends**, but does not contribute to increases in R&D, real investment, or M&A.
- After the formulation of the Corporate Governance Code, the probability of sale of cross-shareholdings has increased.

Engagement

Engagement with institutional investors leads to better governance and higher share prices.

Shareholders

- **The higher the ratio of active investors, the better the R&D results of manufacturing companies become.**
- **Higher company's institutional / foreign shareholder ratio leads to the higher productivity and market valuation.**

Note: "Empirical research" refers to analyses on how corporate governance reform initiatives (including the appointment of outside directors) have affected corporate performance measured by ROE, ROA, share price, etc., using statistical methods.

Source: Prepared by JFSA, using materials provided by Professor Hideaki Miyajima, Waseda University, Associate Professor Takuji Saito, Keio University Graduate School, and Professor Tsumuraya

Overview of the interviews with companies on corporate governance reforms

- FSA, with the cooperation of Keidanren (Japan Business Federation), conducted a series of interviews with companies in order to look into their corporate governance initiatives and their views.

[Interviewed companies (in alphabetical order)]
Astellas Pharma, Ebara, FP Corporation, Omron, Kao, Sun Frontier Fudousan, Shin-Etsu Chemical, Suzuki Mo~~r~~tor, Sumitomo Electric Industries, TDK, Nitori HD, Fujitsu, Mitsui & Co., Mitsui Fudosan, Yamaha, Yokogawa

Key Takeaways

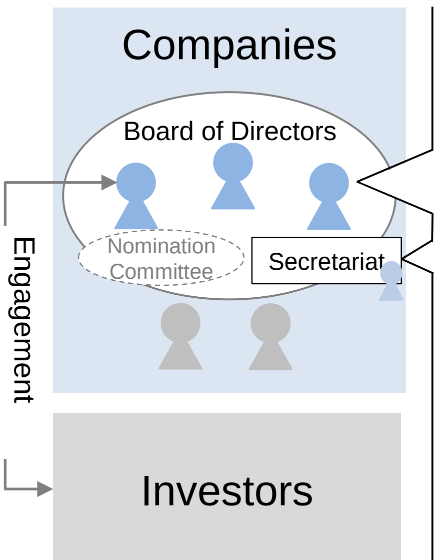
Evaluation of the Corporate Governance Reforms

- Most companies, including the management side, said that enhanced deliberations by the board of directors and deepened discussions on medium- to long-term business strategies had a positive impact on their business, and that engagement with investors gives useful suggestions to the management, suggesting that the direction and effectiveness of corporate governance reforms are widely supported.

Key Issues

- Given the pressure to comply on the companies' side, if the Corporate Governance Code refers to even details of businesses, it may lead to formalistic responses by companies, resulting in an insubstantial reforms.
- High-quality engagement should be promoted by addressing issues such as exercise of voting rights based on a check-the-box by institutional investors, the lack of opportunities for engagement at medium-sized and smaller companies, and the difficulty for companies to identify beneficial owners.

Opinions of Companies



Corporate Governance

- Corporate governance reforms help to increase corporate value in the long-run, and the direction of the Corporate Governance Code that aims to improve corporate value is highly appreciated.

Board Effectiveness

- By original and ingenious initiatives, such as methods of explanations provided by the management to the Board, the Board of Directors' deliberations were enhanced, and valuable suggestions and advice were provided by outside directors, which led to decisive decision-making.

Relation with the Management

- Medium - to long-term management strategy was discussed at the Board of Directors, and authority was transferred to executives. The monitoring of management through progress report increased the speed of decision-making and enabled management in line with the medium - to long-term strategy.

Management Appointment

- By gaining trust from within the company, a nomination committee can endow the nominated management team with strong leadership.

Evaluation of the Board Effectiveness

- Applying a PDCA cycle of corporate governance reforms that hinges upon the evaluation of the board's effectiveness can substantiate the functions of the board.

Engagement

- Engagement by the president, the chairman of the board and outside directors actively and continuously with investors who see the company on a medium to long horizon and give them helpful suggestions.

Comments at the Japan Corporate Governance Forum

About Japan Corporate Governance Forum

- The following statement was made by PM Kishida in his speech at NYSE on September 22, 2022.

> One very important policy is corporate governance reform. […] We will accelerate and further strengthen corporate governance reforms in Japan, such as establishing a forum in the near future to hear from investors from around the world.

- Based on this, Japan Corporate Governance Forum was established and has been held as follows.

1st meeting on Sep. 27, 2022: Discussion with Asian Corporate Governance Association (ACGA)

2nd meeting on Oct. 3, 2022: Discussion with International Corporate Governance Network (ICGN)

3rd meeting on Jan. 12, 2023: Discussion with investors in New York, USA

In addition, the purpose and results of the Forum are posted on the FSA's website.

Comments at the Japan Corporate Governance Forum (1)

Assessment of Corporate Governance Reform

- Overall, we are optimistic about the progress of corporate governance in Japan. We are highly satisfied with the pace and direction of the initiatives undertaken by the Japanese government.
- After several years since the publication of both codes, corporate governance reforms have started to show significant progress, including increased awareness on the corporate side. We have confidence that corporate governance reform in Japan will continue in the future.
- Since 2013, Japanese companies have been undergoing gradual changes, and some have made substantial advancements. Previously, Return on Equity (ROE) was not emphasized in companies' documents, but now it is included in the documents of every company.
- It is important to note that improving corporate governance does not immediately translate to improved performance. There is a time lag, so a long-term perspective is necessary. We perceive that the Japanese board of directors is evolving, and there is no doubt that it is moving in the right direction.
- Efforts to reform corporate governance will not yield immediate results, but over the course of 10, 20, or 30 years, they will contribute to increased corporate value and sustainable growth.
- Corporate governance aligns the interests of investors with those of the corporation, benefiting both parties and enhancing returns to shareholders and investors.
- Corporate governance reforms aim to build investor confidence gradually through initiatives such as direct dialogue between outside directors and shareholders.
- （When assessing corporate governance reforms from the perspective of increasing corporate value,）asset owners and investors in Europe and the U.S. acknowledge that improvements have been observed in Japanese companies. However, they believe that the pace of improvement is relatively slow. Particularly in terms of capital management, greater attention should be given to board independence, diversity, effectiveness including skill sets, the composition of nomination and remuneration committees, independent directors, and an enhanced understanding of capital markets.
- （Regarding the assessment of corporate governance reforms from the perspective of increasing corporate value,）it is crucial to have appropriate skill sets on the board of directors and to emphasize the contribution of outside directors. We believe that the progress in these areas has been slow and will continue to be a significant topic for discussion.

Comments at the Japan Corporate Governance Forum (2)

Challenges in enhancing corporate value over the medium to long term

Profitability and growth potential considering the cost of capital

- Although there is a growing awareness of the importance of improving return on equity (ROE) and capital efficiency, not all companies recognize this. Investors need to present best practices and standards to help companies explain their cost of capital.
- Factors such as capital efficiency, growth potential, and ROE are crucial for investors to include in their portfolios.
- Hoarding cash is a significant issue. If management were to use this cash for the benefit of shareholders, it would attract funds from global investors to the Japanese market and revitalize the economy.
- Japanese companies tend to hoard cash due to the emphasis on perpetuity rather than growth and increasing corporate value. This is a sign that the board of directors and general shareholders' meeting are not functioning properly. The capital provided by shareholders is meant for the benefit of shareholders, and investing cash would be beneficial for Japan's capital markets and economy.
- Some companies unnecessarily accumulate retained earnings, and sanctions are needed to make them discharge their retained earnings. Despite having significant retained earnings, they lack suitable investment opportunities, incentives to remain listed, and a greater incentive to maintain a high percentage of votes in favor of the appointment proposal rather than improving the share price.
- Companies with extremely low ROE and P/B ratios below 1x have been able to continue their business without any penalty. Companies failing to meet the minimum ROE standards for several years should be delisted compulsorily.
- Companies with excess cash in their balance sheets can easily increase their ROE through share buybacks and other means. It is necessary for investors to encourage individual companies to change their behavior.
- There is a lack of disclosure on future directions, such as EPS forecasts.
- It is the responsibility of directors to address shareholder interests, including share price and profitability, with management.
- CEOs are not being challenged by the Board of Directors regarding the cost of capital. Therefore, further independence and diversity of the board of directors are needed. Simply appointing one-third of independent outside directors on the board will not sufficiently increase the challenge to CEOs.
- Even when reasonable proposals are made by activists from the perspective of cost-of-capital efficiency, almost all such proposals are rejected, especially in small- and mid-cap stocks.
- Japanese listed companies have excessive compliance attitude and insufficient strategic planning.
- The company should establish targets for return on equity and focus on enhancing shareholder returns.

Comments at the Japan Corporate Governance Forum (3)

Challenges in enhancing corporate value over the medium to long term

Addressing sustainability challenges, including initiatives focused on human capital

- Promoting disclosure on human capital is a recent trend, and the following points are particularly important:
  - Provide training to enhance employee skills.
  - Disclose efforts made to invest in employees and improve employee engagement based on internal surveys.
  - Regarding gender diversity, disclose targets set by companies for the representation of women in executive positions, internal initiatives to improve diversity, and differences in employment and turnover rates between men and women. It would be beneficial to provide this disclosure in English as well.
  - Employees should be viewed as assets rather than liabilities across the value chain.
- Regarding sustainability disclosures, it is crucial to disclose the extent to which the core business contributes to the achievement of the Sustainable Development Goals.
- Improving gender diversity is an urgent matter. Regarding the appointment of women to the board of directors, we propose the following:

(i) Revision of listing rules for TSE Prime Market:
1. Introduce a requirement of at least one female board member for new listing companies.
2. Implement a target of at least one female board member for all companies as soon as possible, with a goal of two female board members over the next 2 or 3 years.
3. Aim for a minimum of 30% female board members by 2030.

(ii) Revision of the Corporate Governance Code:
1. Establish a target of at least 30% female board members for all companies listed on the Prime Market by 2024 as soon as possible, with a minimum requirement of 2 female board members for all other listed companies.
2. Strive for at least 30% female board members for all listed companies by 2027 as soon as possible.

- Board diversity is crucial. In Japan, the appointment of directors is often viewed as a reward for contributions to the company. However, appointing individuals from outside the company, non-Japanese individuals, and women can greatly enhance the accountability of the board of directors.
- It is regrettable that there has been limited progress in promoting women to management positions.
- In addition to female directors, it is important to increase the number of foreign directors to enhance board diversity.
- Regarding board diversity, the skill matrix disclosed by companies is often seen as a formality and does not accurately reflect the actual situation.
- One of the major expectations for the future of the Japanese economy is higher wages. Wage increases are seen as a catalyst for the revival of the Japanese economy. Since wage growth is linked to GPIF’s investment yield target, if wages rise, the investment yield target is expected to increase as well. Consequently, the cost of capital for Japanese equities is anticipated to rise, leading to higher ROE.

Comments at the Japan Corporate Governance Forum (4)

Challenges in enhancing corporate value over the medium to long term

Fulfilling the functions of independent outside directors, among other things

- The primary role of the board of directors is to supervise management, in collaboration with internal audit, to hold management accountable for achieving the Key Performance Indicators and other targets set by management itself.
- The board of directors also plays a vital role in keeping management informed about changes in the external environment, including social and economic conditions, as well as the competitive landscape of the marketplace. When the external environment upon which the company's business strategy is based undergoes changes, it is important for the board of directors to consider modifying the relevant business strategy.
- It is crucial to (1) have a fully independent board of directors and (2) ensure that the board discloses discussions regarding takeover proposals and tender offers.
- The percentage of companies listed on TSE's Prime Market, which have a majority of independent outside directors representing the interests of minority shareholders on the board of directors, is significantly lower than the global standard.
- While the appointment of independent outside directors is increasing, there is a tendency for them to be nominated by entities that hold shares of the company.
- Many independent outside directors do not actively participate or voice their opinions during board meetings, thus not fulfilling their function effectively.
- Directors have a duty to the company, and outside directors who work for the CEO are ineligible. Determining whom the director is working for is important as it significantly impacts how the interests of shareholders, employees, and other stakeholders are considered.
- To ensure that outside directors have the necessary professional and ethical guidelines, as well as a thorough understanding of the company, they should regularly meet with each other before and after board meetings to exchange ideas.
- It is crucial for independent outside directors to engage in direct dialogue with investors.
- Insufficient availability of qualified individuals to serve as directors is a concern. It is undesirable for the same person to hold the position of an outside director in multiple companies simultaneously. Serving as an outside director for numerous companies does not allow enough time to be devoted to each company.
- A significant problem is that there is no requirement under the current system for the separation of the CEO and chairman of the board of directors: The CEO is expected to be involved in management decisions, while the directors are expected to supervise and restrain the management team from a position that is independent and considers the impact of social trends, such as climate change, on the company. The roles of these two positions are fundamentally different and critical.

Comments at the Japan Corporate Governance Forum (5)

Challenges in enhancing corporate value over the medium to long term

Fulfilling the functions of independent outside directors, among other things

- It is important for independent directors to serve as chairpersons of various committees in addition to board meetings and bring fresh outside input to these committees.
- Increased transparency about the chairpersons and outside members of the nomination and remuneration committees is necessary in order to strengthen their roles and responsibilities. Investors do not know who the chairpersons and outside committee members are in the committees.
- The nomination committee should disclose the process for selecting officers and the board chairperson, providing evidence that proper consideration has been given to the candidates.
- To achieve our managerial goals, it is crucial to have a team of directors equipped with the necessary tools. The skills matrix is a valuable tool in identifying these skills. However, many Japanese companies currently lack a clear understanding of their management goals.
- Leading practice entails establishing a system for the third line of defense in the three-line model (internal audit) to report to the board of directors. Certain safeguards for internal audit can be ensured by requiring the approval of the audit committee for the selection or removal of internal auditors.
- It is important for management to be receptive to the perspectives and arguments put forward by outside directors.
- The portion of management remuneration tied to company performance is currently minimal, resulting in little incentive to improve performance. All directors and management should have a significant financial stake in the business, including the granting of stock options. Furthermore, guidelines for remuneration should be established, disclosed, and compliance with these guidelines should be reported.

Comments at the Japan Corporate Governance Forum (6)

Challenges concerning the dialogue between companies and investors

Investors' Initiatives

- When engaging in dialogue with companies, we follow a specific approach. Firstly, we screen and narrow down the target companies by focusing on the composition of their boards of directors and their efforts to ensure diversity, including the involvement of outside directors. Then, we delve deeper into how they are addressing the issues they face.
- The fiduciary responsibility in index investing is not adequately fulfilled.
- Low salaries hinder the development of investment personnel. Therefore, the treatment of investment personnel should be enhanced.
- Asset managers should fulfill their fiduciary responsibility by strengthening the disclosure of voting results and other pertinent information, instead of solely focusing on corporate governance..
- Currently, there is no service available that effectively consolidates data on individual voting results and accompanying reasons.
- Disclosure has resulted in increased costs for corporations. However, the value of these costs depends on whether asset management firms can effectively utilize the disclosed information. Nevertheless, the sheer volume of items to be reviewed poses a challenge, and even the willingness of their personnel to thoroughly examine these items is lacking.
- Due to disrespectful behavior exhibited by certain investors, a sense of avoidance towards foreign investors has been observed among corporate management.
- Major Japanese financial institutions face conflicts of interest between their asset management businesses and their core operations, such as banking, securities, and insurance.
- A significant number of asset management firms do not receive compensation tied to investment performance. However, enabling the implementation of performance-linked compensation would alter the nature of engagement.
- In the United States, the growing presence of institutional investors in the stock market has led to heightened competition among asset management firms to secure mandates. Conversely, in Japan, competition regarding services, costs, and performance within the asset management sector is relatively weak.
- There is a limited number of asset owners who possess the knowledge and capability to invest funds in activist asset managers. It is expected that mechanisms will be established to create more asset owners with the knowledge and ability to invest funds in activist asset managers.
- Japanese companies have a deficiency in checks and balances on management through the general shareholders' meeting.

Comments at the Japan Corporate Governance Forum (6)

Challenges concerning the dialogue between companies and investors

Improvement in information disclosure

- To provide investors with additional information, annual securities reports should be submitted 30 days prior to the general shareholders' meeting.
- Annual securities reports encompass a wide range of information that investors rely on, and it is indeed an excellent suggestion to disclose them before the AGM. Presently, when it comes to cross-shareholdings, only information from one year ago is available for reference. It is conceivable that the timing of the general shareholders' meeting could be postponed.
- The concentration of shareholder meetings within a few weeks renders it impractical to thoroughly analyze a company and exercise voting rights after careful consideration. It is advisable to stagger the timing of AGMs, allowing investors more time to exercise their voting rights.
- Disclosure practices in Japan are not as comprehensive as those in the United States and Europe. For instance, Japan lacks the same level of granularity as the United States when it comes to segment information and other aspects.
- Fund providers are exerting pressure to increase reporting and encourage ESG-based investment actions, as they seek greater disclosure on ESG matters.
- ESG disclosure loses its significance if it becomes a mere check-the-box exercise..
- It is important to highlight that there has been a trend in Japan to undermine constructive engagement, which could potentially undermine the promotion of bottom-up stewardship activities and hinder the development of a market for corporate control in the country.
- In certain instances, companies exhibit reluctance to engage with their investors, and gaining access to top management is particularly challenging, especially in many Japanese companies.
- Investing in a company without the ability to directly communicate carries an additional level of risk. Consequently, even if you consider it a promising investment, taking a significant position becomes challenging.
- Japanese company management has become more receptive to investor engagement compared to the past. Although they are willing to meet with us, they have not yet translated their willingness into concrete actions.
- It is crucial for authorities to consider the incentives that will encourage companies to enhance their disclosure practices and investors to engage in further dialogue.

Main opinions at the Japan Corporate Governance Forum (8)

Challenges concerning the dialogue between companies and investors

Facilitating dialogue with global investors	

- Visualizing companies that excel in corporate governance is beneficial in terms of enhancing investor confidence and providing incentives to companies to improve their governance practices.
- Foreign investors often express the view that English-language disclosure by Japanese companies should be expanded. Some of the materials publicly disclosed by Japanese companies are available only in Japanese, and even when machine translation is employed, they do not always translate accurately or effectively into English.
- The crucial aspect lies in the ability to communicate in English within the investment environment. Efforts should be undertaken to expand English-language reporting, including small and medium-sized enterprises.
- Japanese companies often exhibit an overreaction to foreign activists, even though these activists often present constructive proposals that are widely supported by long-term investors.

Legal Issues

- The interpretation of the "act of making important suggestions" and "joint holders" within the framework of the large shareholding reporting rule remains unclear. If these aspects are clarified, it would enable more in-depth suggestions to be made to companies regarding management strategy and corporate governance.
- The interpretation of the system, specifically regarding joint holdings and the act of making important suggestions under the large shareholding reporting rule, requires further clarification. This lack of clarity may pose as an obstacle to collaborative engagement. Collaborative engagement between foreign investors and Japanese investors presents an opportunity for Japanese companies to gain insights from diverse perspectives and adopt best practices.
- Foreign investors are concerned about engaging in collaborative engagement, and there is a pressing need for greater clarity. Introducing a safe harbor approach, similar to those implemented by other countries, could be advantageous.
- While it is important to allow for differences and uniqueness in the design of engagement systems in each country, a high level of transparency is crucial to encourage stewardship activities. For instance, a well-defined deadline for the submission of large shareholding reports and a clear definition of beneficial joint holders would promote stewardship activities.
- Partial tender offers can be coercive towards minority shareholders. While a complete prohibition may not be feasible, it is important to establish guidelines that protect the rights and interests of minority shareholders..
- The introduction of mandatory tender offers, similar to those in Europe, would greatly benefit minority shareholders.

Main opinions at the Japan Corporate Governance Forum (9)

Challenges concerning the dialogue between companies and investors

Market environment issues

- When considering the market for minority shareholders and investors, the legitimacy of a listed subsidiary's existence may come into question.
- There are cases where the parent company is unaware that its actions are negatively impacting the interests of minority shareholders in the subsidiary.
- When a controlled company has only one or two outside directors, these directors often find themselves isolated from the rest of the board, making it challenging for their opinions to be effectively reflected in board meetings.
- A majority vote of the minority shareholders should be required for the election of directors.
- There are instances where the premium offered in an acquisition is significantly lower compared to the fair market value of the shares, particularly in cases where subsidiaries are acquired by their parent company. This often leads to frustration among investors, as the purchase price may be at a substantial discount to the book value or net asset value. In situations where the acquirer holds majority voting rights, there are limited avenues for recourse for minority shareholders.
- The prevalence of cross-shareholdings continues to be a concern. Although cross-shareholdings are often justified in some cases, such as in business alliances with clear economic benefits, there remains a lack of transparency surrounding these arrangements. This poses an issue from the perspective of corporate governance.
- Cross-shareholdings represent the most persistent and frustrating barriers hindering foreign investors' endeavors to enhance corporate governance in Japanese companies. The absence of stringent listing standards in the Prime Market has been a source of disappointment for many investors.
- Many investors take issue with cross-shareholdings that exceed 10% of a company's ownership. Cross-shareholdings, particularly when there is no business relationship involved, often indicate that the company has no intention to sell or exercise voting rights associated with those shares.
- Cross-shareholdings present a significant complexity. It is not just the cross-shareholdings themselves, but also supportive shareholding that pose major obstacles to reasonable shareholder proposals. The presence of cross-shareholdings often provides protection to management and tends to limit their consideration of the interests of shareholders who are not part of the cross-shareholding arrangement.
- Cross-shareholdings are occasionally justified as a means to sustain business relationships. However, if transactions were to be discontinued, it would imply that the company is engaging in non-competitive business practices that could be easily replaced by alternative partners. Companies should prioritize conducting business with other entities that offer the highest profitability. The perpetuation of unjustifiable business relationships solely based on cross-shareholdings is also a concern.
- It is challenging to ascertain the specific entities holding cross-shareholdings in companies. There is a need to enhance the transparency of the cross-shareholdings structure.

Main Opinions at the Japan Corporate Governance Forum (10)

Challenges concerning the dialogue between companies and investors	Market environment issues	

- The market restructuring undertaken by the Tokyo Stock Exchange is disheartening as it does not fully align with the vision of establishing a prime market exclusively for large companies with robust governance. There is a need to strengthen the listing criteria, including the implementation of appropriate transitional measures.
- Establishing a market environment that fosters mergers and acquisitions (M&A) is crucial for the success or failure of corporate governance reform. In a conducive M&A environment, management will place greater emphasis on Return on Invested Capital (ROIC), and there will be increased pressure to divest cross-shareholdings.
- One contributing factor to the price-to-book (P/B) ratios below 1x observed in many companies is the presence of listed companies that do not necessarily need to be listed. To address this, it is essential to establish a market environment that enables external pressure through the implementation of rules that facilitate Tender Offer Bids (TOB).
- An excessively permissive corporate control market can foster a short-term mindset. However, without a functioning corporate control market to some extent, it can also encourage rent-seeking behavior by management. This tendency towards rent-seeking is particularly pronounced in Japanese corporate management.

Survey on Stewardship Activities

Summary of the Survey

- Mizuho Research & Technology conducted a commissioned comprehensive survey to assess the actual stewardship activities of institutional investors, identify key issues, and provide recommendations for promoting more substantial engagement. The survey spanned from January to March 2023 and involved a questionnaire distributed to 136 institutional investors, as well as in-depth interviews conducted with 16 institutional investors. The aim of the survey was to gain insights into the current landscape of stewardship practices and generate valuable recommendations based on the findings.

Survey on Institutional Investors

Targets:

A total of 232 companies that have accepted the Stewardship Code as of December 31, 2022, including 6 trust banks, 202 investment trusts, investment advisory firms, and 24 life and non-life insurance companies.

Number of respondents :

136 companies (collection rate: 59%)

Period:

January 30 - February 20, 2023

Interview with Institutional Investors

Targets:

Investment trusts and investment advisory firms 12
Life insurance company 1
Asset Owner 3

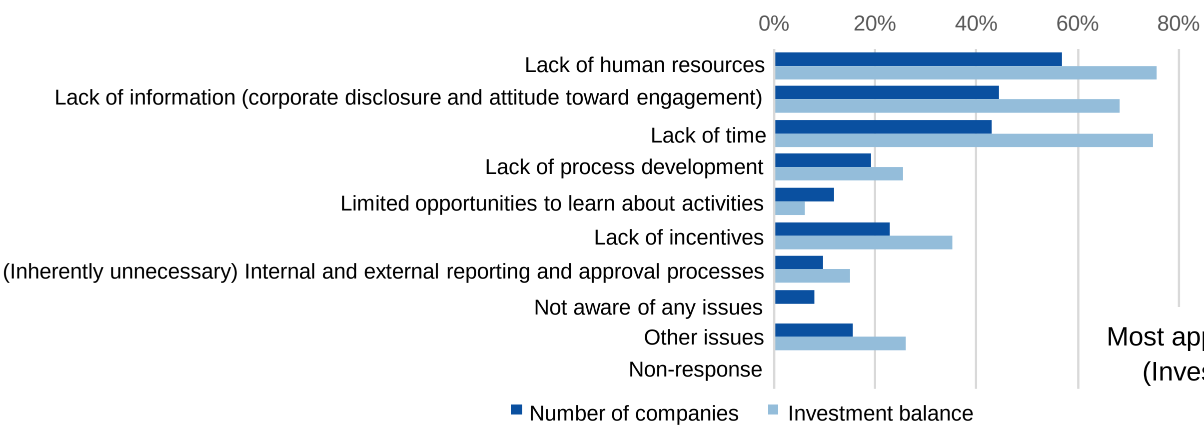
Period:

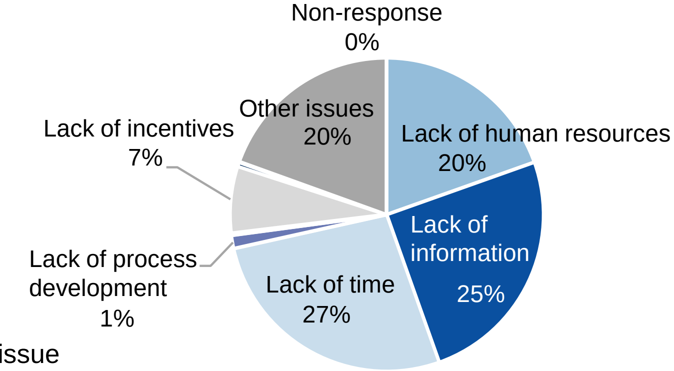
February 14 - March 7, 2023

Recognition of Issues by Asset Management Institutions

- The survey results indicate that asset management institutions have identified the following issues:
  1. Insufficient resources (human resources and time) for engagement.
  2. Inadequate behavioral change and attitude within portfolio companies.
  3. Opportunities for improvement in process construction (PDCA cycle).
  4. Lack of incentives to allocate costs and budgets for engagement initiatives.

Challenges in conducting more effective stewardship activities

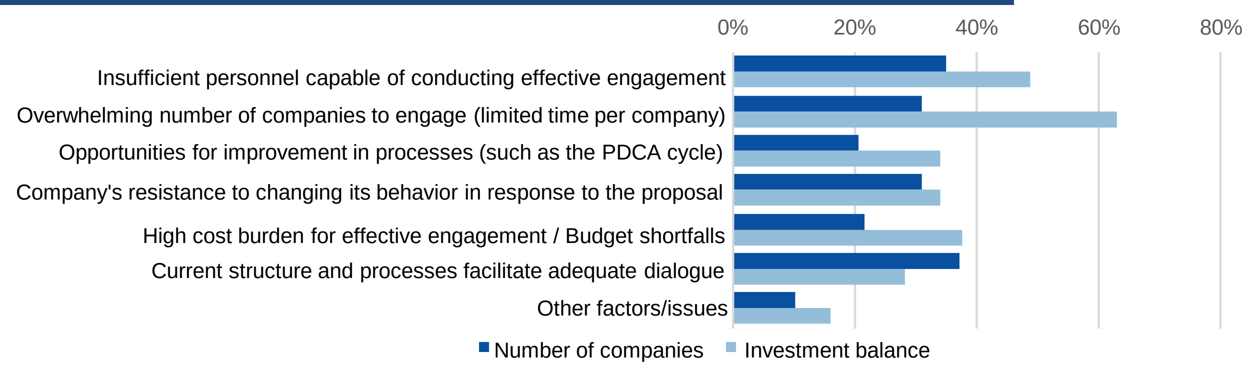




Most applicable issue (Investment balance)

(Note) Number of valid responses: 135
(Domestic stock investment balance: 206 trillion yen)

Challenges in conducting stewardship activities to provide new insights to companies



(Note) Number of valid responses: 97 (Domestic stock investment balance: 206 trillion yen)

(Source: Mizuho Research & Technologies Co., Ltd. "Final Report of 'Survey on Stewardship Activities of Institutional Investors, etc.'"

Individual efforts at each asset management institution (Lack of resources (i))

Lack of resources (human and time) for engagement

Human Resource Development

Efforts to improve professional expertise and dialogue skills	[Summary] Based on the belief that engagement requires a certain level of knowledge and experience, the asset management institutions are creating opportunities for younger staff members to learn from the knowledge and communication skills of more experienced staff members. In addition, the institutions are also working to improve knowledge by sharing best practices among engagement staff, holding (in-house) study sessions for engagement staff to improve their expertise, and holding study sessions outside the institution and exchanging opinions.

(Examples of Specific Efforts)

- In order to gain the trust of senior management and executives with whom we engage in dialogue, it is important to express constructive opinions, and we intend to develop human resources with knowledge other than financial knowledge (e.g., knowledge of management strategy, human resource strategy, etc.). On-the-job training is the core of human resource development, and engagement is conducted by pairing experienced staff with younger members of the team. In addition, the institution is working to acquire knowledge through participation in various government-related committees and multiple participants in opportunities to interact with academics.
- The reality is that the content and level of engagement varies from person to person in charge. In order to homogenize the engagement quality, an engagement meeting has been established and a cycle of sharing good practices by each person in charge has been conducted once a quarter.
- Regularly exchanges views with U.S. investors. Specifically, case studies were conducted with certain companies to determine what issues and over what time frame would be most effective to conduct engagement.
- In terms of dialogue skills, experienced staff members and younger staff members are working together to share their knowledge by engaging in dialogue with companies. In addition, engagement staff generally have sufficient career experience (knowledge) in corporate analysis, but further acquisition of ESG knowledge is necessary. Institutions are participating in impact analyst training and utilizing e-Learning related to TCFD. In addition, they place particular emphasis on acquiring practical knowledge within their work and share the status of their activities and accumulate knowledge at weekly company-wide meetings.

Devising evaluation and incentive systems	[Summary] To encourage effective engagement, items related to engagement activities will be incorporated into the evaluation items (incentives) for those in charge.

(Examples of Specific Efforts)

- Qualitative evaluation of whether the institution is continuously acquiring knowledge and whether it is conducting activities in accordance with the process.
- Qualitative evaluation of the content of dialogue records and internal case sharing
- Evaluation in consideration of progress in milestone management, etc.

Fostering the Next Generation	[Summary] The institutions conduct educational activities for university students as part of its efforts to develop human resources from a long-term perspective.

(Examples of Specific Efforts)

- The younger generation is highly interested in ESG, and the institution is working to promote ESG to the younger generation, including students (specifically, by cooperating in ESG investment seminars for university students), which will lead to internship opportunities, thereby changing the generation.

Individual efforts at each asset management institution (Lack of resources (ii))

Lack of resources (human and time) for engagement

Use of External Resources

Information sharing with other companies	[Summary] (Especially on themes common to the industry as a whole) Sharing information with other asset management institutions improves and accumulates knowledge of the industry as a whole.

(Examples of Specific Efforts)

- Serving as the chairpersons of the industry associations every other year, selecting themes for collaborative engagement and compiling recommendations for the associations, taking into account global trends. This process is considered to be an opportunity for other members to gain knowledge as well. (For example, regarding climate change, information is shared with members on what theme is the most beneficial to address.)

Use of Collaborative Engagement	[Summary] An extensive information and knowledge can be acquired by participating in collaborative engagements (in addition to gaining advanced knowledge through study sessions and exchanges of ideas at the initiative, the knowledge of NGOs and academics can also be utilized. Also, it is possible to learn engagement techniques by sitting in on engagements with foreign investors). .

(Examples of Specific Efforts)

- The asset management institutions are also members of the Collective Engagement Forum and actively utilize it. In the Forum, roles are assigned to each of the participating institutions, and each institution is expected to take a lead role in high-quality engagement. In addition, they participate in a number of global initiatives and has a policy of engaging in initiatives in which it participates in a substantive manner (i.e., serving as the lead manager and being involved in the management of the initiative, etc.).

Responding to engagement requests

Responding to engagement requests	[Summary] Responds to requests for engagement from companies which have become ineligible for engagement.

(Examples of Specific Efforts)

- The asset management institutions are willing to respond to requests for dialogue from companies that are willing to make improvements and have set up a dialogue desk on the exercise of voting rights and ESG issues. In principle, the institutions respond to requests as long as it is convenient for thems to do so.
- Recently, requests for ESG dialogue have been increasing, and the policy is to respond in principle to requests even from small and medium-sized companies. On the other hand, some companies are reluctant to have a dialogue, and it is necessary to change their mindset. The asset management institution also has a small- and mid-cap strategy, and its fund managers sometimes conduct dialogue.

Individual efforts by each asset management institution (changes in behavior of portfolio companies (i))

Insufficient behavioral changes and attitudes in portfolio companies

Adequate research and internal collaboration

Advice and expression of opinions based on the company's situation	[Summary] The asset management institutions conduct in-depth research on each company prior to an engagement in order to provide advice tailored to the individual circumstances of each portfolio company, decides on the content of the engagement in collaboration with the ESG specialist department and the investment management division, and presents the research results as materials to the portfolio company.

(Examples of Specific Efforts)

- For companies that they focu on engaging, the asset management institutions prepare individual materials for engagement. The submission of materials has the advantage of making it easier to share their awareness of the issues within the portfolio company, which in turn makes it easier for engagement to progress.
- The institution sends a “Dialogue Agenda” to each company with which the institutions has a dialogue about two weeks prior to the engagement. The agenda is tailor-made for each company, so that the institution can share with the company its awareness of the issues focusing on as an investor, and the institution hope that the agenda will help the company improve its corporate value by providing it with internal feedback on the agenda. By sending out the agenda in advance, the company recognizes that it is also used to select suitable participants for the dialogue, and in some cases, when there are a wide range of topics, there are as many as 10 participants.
- For target companies, ESG integration analysis (performance forecast for the next 5 years after evaluating ESG factors) is conducted. In addition to this, when conducting focused engagement, the institution considers whether the company's management itself is optimal, and if not, what kind of management would increase corporate value more, and when sufficiently organized, the institution incorporates this into its materials to make proposals.
- To enhance corporate value, it is important to have a good understanding of individual company and industry conditions, and the institution emphasizes collaboration between analysts who know the company well and voting officers who have knowledge of governance and ESG issues. Those personnel sometimes sit in on dialogues and exchange opinions on a daily basis. The institution believes that internal collaboration alone is insufficient to accumulate specialized knowledge, so it seeks to acquire external information, including from overseas, through initiatives. Initiatives focusing on detailed themes are also utilized to obtain comprehensive information.

In-house collaboration	[Summary] In order to improve the quality of engagement, the asset management institutions emphasize collaboration between the dedicated engagement department and the investment department.

(Examples of Specific Efforts)

- The institution has a dedicated department for stewardship activities, but it is a challenge to what extent the dedicated department is able to look at individual companies. Analyst/fund managers conduct research evaluations of individual companies, so it is important for the dedicated department and analyst/fund managers to work together. Based on this recognition, in addition to discussions between the two after individual interviews and engagements, the two parties take time to share information on a regular basis. Specifically, at monthly stewardship meetings and ESG meetings, a wide range of key people related to ESG are brought together to share information on a variety of topics, etc., besides that, each investment management group and dedicated department share the status of ESG engagement activities by the dedicated departments on a monthly basis. In addition, the content of interviews and engagements (interview memos) are shared with the investment management divisions so that they can access them at any time.

Individual efforts by each asset management institution (changes in behavior of portfolio companies (ii))

Insufficient behavioral changes and attitudes in portfolio companies

Involvement in implementing the engagement

Selecting "dialogue partners"	[Summary] To encourage companies to take action, the institutions are selecting dialogue partners.

(Examples of Specific Efforts)

- The asset management institution understands that engagement is an “effort” to resolve issues, and the institution believes that it is necessary to have a dialogue with those who can judge and make decisions on how to address issues (e.g., the CFO if there are issues related to shareholder returns). If access to decision makers is not available, the impact and effectiveness of the engagement will be greatly reduced, and in such cases, the institution takes measures such as sending a letter to the Board of Directors. Note that the institution is in regular contact with the companies with which it engage, and the companies are aware that the institution has a certain level of retention, so access routes to decision makers are often secured.
- The asset management institution has taken steps to ensure that engagement is not treated as ad hoc activity by asking that the content of the dialogue be fed back to the Board of Directors when it engages with the person in charge. As for the parties with whom the institution engages in dialogue, there are cases where it is effective to engage in dialogue with outside directors, and there are cases where it is more effective to engage with IR staff rather than management, and this is a case-by-case basis. Therefore, it is important on the part of the asset management institution to determine such matters.

Selecting engagement channel	[Summary] The asset management institutions use not only "investor outreach to portfolio companies" but also other methods (i.e., "company-to-company outreach" and outreach to government agencies, etc.).

(Examples of Specific Efforts)

- In some cases, the asset management institutions may need to address issues that cannot be resolved through the efforts toward a single company, and the institutions may need to reach out to industry associations or government ministries and agencies to address them.
- The asset management institutions believe that it is also effective to have multiple sources of encouragement to promote corporate transformation. For example, with regard to human capital, they held a panel discussion with companies that are making advanced efforts on the theme of human resources. In the sense of providing an opportunity to hear the real voices of other companies' efforts, they believe this is beneficial in encouraging companies to take action. They also bring companies together for the same purpose, setting up meetings between key personnel from companies that are implementing best practices and key personnel from companies to be engaged (whose efforts are still in progress).

Individual efforts by each asset management institution (changes in behavior of portfolio companies (iii))

Insufficient behavioral changes and attitudes in portfolio companies

Involvement in implementing the engagement

Providing the "investor' s perspective"

[Summary] Provides an investor's perspective (evaluation of portfolio companies and comparison with competitors) in order to help portfolio companies take steps to resolve issues.

(Examples of Specific Efforts)

- From an investor's standpoint, the asset management institution conducts discussions after informing the portfolio company of what aspects of the company the institution values and why holding the share, etc. By conducting dialogue based on this premise, it is possible to confirm that the assumptions the institution has in mind are consistent with the direction of the portfolio company, and subsequent dialogue will be beneficial. The institution also believes that it is beneficial to communicate its viewpoint of evaluation as a capital market. (For example, if the company recognizes its cost of capital as 6%, but the capital market evaluates it as 10%, the institution engages in dialogue about why this difference exists and how the difference can be closed, etc.)
- The institution introduces best practices and offers suggestions for improvement on a diverse range of topics. For information disclosure, the institution uses AI to score the completeness of descriptions in integrated reports and securities reports and share the results with portfolio companies. Visualization of the relative positioning of the company to its competitors is of great interest to the companies. The institution also provides these results to the companies as reference materials, and the institution recognizes that they are useful in terms of directly communicating oits awareness of issues, etc., to management.

Formulation of effective voting standards, Dissemination, feedback of exercise results

Integrating engagement and voting

[Summary] Engagement and voting are both aimed at increasing the corporate value of portfolio companies, and are managed in an integrated manner.

(Examples of Specific Efforts)

- The asset management institution believes that the exercise of voting rights is a tool to enhance the effectiveness of engagement and that the two should be operated inseparably and in unison. For example, if there is an engagement theme such as shareholder return or capital policy, once the institution opposes a proposal for appropriation of retained earnings, it does not necessarily mean that the institution will exercise its voting rights in the same way in the future. If the company makes a positive change, such as raising the dividend payout ratio, the institution may vote in favor of the proposal even if it has not yet reached the level it is seeking, because the institution believes that voting in favor of the proposal once will be beneficial in future engagements. If no further improvement is seen after that, the institution may vote against it again. The institution believes that there are not many cases in which a company can reach the level sought by investors in a short period of time, and that approving a positive change as a middle ground can be expected to have the effect of encouraging further improvement.
- The voting criteria are formulated in a manner that allows for a certain degree of discretion and is designed to easily reflect the content of the engagement. In addition, the exercise decisions are made by the person in charge of engagement, and since the person in charge is not changed for several years, engagement over several years can be reflected in exercise decisions, etc. This is also an effort to integrate engagement and voting and to ensure highly effective exercise of voting rights.

Individual efforts by each asset management institution (changes in behavior of portfolio companies (iv))

Insufficient behavioral changes and attitudes in portfolio companies

Formulate and disseminate highly effective voting criteria, and provide feedback on the results of the exercise of voting rights

Formulation of voting criteria based on the situation of Japanese companies	[Summary] The situation of Japanese companies identified through engagement activities is reflected in the voting criteria.

(Examples of Specific Efforts)

- In order to make the exercise of voting rights more in line with actual conditions, the asset management institution has formulated voting criteria based on the attributes of the company. For example, the criteria for exercising voting rights in consideration of ESG issues have been established for companies that consider addressing climate change issues to be an important issue and companies with a large number of cross-shareholdings.

Dissemination of their approach to the exercise of voting rights	[Summary] It is important for portfolio companies to understand the voting standards and the thinking behind them (why such standards are formulated) (a reasonable length of time is set aside before the AGM to familiarize them with these ideas) so asset management institutions are disseminating those thinking.

(Examples of Specific Efforts)

- In order to make the exercise of voting rights effective, it is also important to have companies understand the thinking behind the voting standards. For this reason, we revise the voting standards in November of each year (in order to make companies aware of and deepen their understanding of the voting standards), allowing a sufficient period of time from the time of the AGM, and then the asset management institution follows a cycle of understanding the status of companies through engagement, making exercise decisions, and considering the standards for the following year based on the results. In addition, opportunities to disseminate its approach are provided at seminars for companies and training sessions for directors and officers. In addition to these efforts, the institution is also taking steps such as documenting "desirable management.

Voting results feedback	[Summary] In order for companies to understand the background of voting decisions, etc., feedback is provided to companies, especially those that are voted against the proposal(s).

(Examples of Specific Efforts)

- The asset management institution has established criteria for the exercise of voting rights through a certain process based on the premise that the exercise of voting rights should lead to the improvement of corporate value, taking into consideration the present and future of the company. All dialogues are compiled in a database, and the contents of the dialogues are taken into account when making decisions on whether to approve or disapprove of a proposal. Although there are cases in which voting decision is in line with the criteria as a result, the institution makes voting decisions after confirming the content of all dialogues with the companies with which it has dialogues. In cases where the decision is against the proposal, feedback is provided to the company on the voting results. In addition, at the time of dialogue prior to exercise, if there is a high possibility of a violation of the criteria, the company is informed of this fact, and care is taken to maintain a relationship of trust with the company.

Individual efforts by each asset management institution (room for improvement in process construction (i))

Room for improvement in process construction (PDCA cycle)

Taking measures for evaluating effectiveness

PDCA cycle for process Improvement	[Summary] PDCA cycle of regularly reviewing one's own activities and responding to issues is used to continually improve the engagement process.

(Examples of Specific Efforts)

- The self-assessment method is based on a questionnaire administered to members of the committee on responsible investment, the decision-making body for stewardship activities, and other members, and discussions are based on the results of the questionnaire. For example, in response to comments that it was difficult to grasp the actual status of on-site engagement at the advisory council for responsible investment (which is responsible for monitoring the decisions made by the committee and its overall operation), an opportunity was provided to report on the engagement.

Reflecting external evaluation/opinions in the effectiveness assessment	[Summary] In conducting effectiveness evaluations, PDCA is carried out using not only self-evaluations but also external evaluations (or external evaluation criteria, etc.).

(Examples of Specific Efforts)

- Since there is no standard item for the effectiveness of stewardship activities that says "it is good if this is done," the asset management institution is assessing the effectiveness of stewardship activities from various perspectives, including external assessments. For example, based on the fact that the PRI assessment included a question on individual disclosure of voting rights exercise, the institution has begun disclosing information on foreign stocks in the belief that such efforts will be required on a global basis in the future. In addition, the institution has been reviewing its response to climate change using the ICAP in the Investor Agenda, which also includes policy engagement with government agencies as an assessment item, and in some cases the institution has reaffirmed the importance of the activities it is emphasizing.

Verification of the effectiveness of engagement	[Summary] In order to assess the effectiveness of the engagement, an evaluation of the effect of the engagement is conducted.

(Examples of Specific Efforts)

- Quantitative evaluation of engagement activities and corporate changes (performance, structure, etc.) are conducted. Last year's analysis confirmed the effects of engagement on the organizational aspects (increase in the number of female executive director, abolition of anti-takeover measures, etc.), but not on the financial aspects. The asset management institution recognizes that one of its future challenges is to reflect these organizational changes in its financial performance, and it plans to continue its efforts.
- The asset management institution is aware of the challenge of the lack of clarity about the costs and returns of stewardship activities. It has collaborated with academic institutions based on this awareness of the issues but remains to be aware of the challenges.
- Although verification is difficult due to the time gap between individual engagements and stock prices, the analysis is based on a certain amount of data. The asset management institutions believes that this type of engagement is particularly beneficial when explaining the significance of stewardship activities to asset owners, and the institution is working with its subsidiaries to analyze the data.

Individual efforts by each asset management institution (room for improvement in process construction (ii), lack of incentives)

Room for improvement in process construction (PDCA cycle)

Use of feedback from asset owners

Use of feedback from asset owners	[Summary] The asset management institutions use the feedback from asset owners to improve the process of their own stewardship activities.

(Examples of Specific Efforts)

- There have been cases where feedback from asset owners was received and used as reference when revising voting guidelines, and where participation in overseas initiatives was considered based on asset owners' opinions as well.
- Reports to asset owners are conducted on a regular basis, reporting on the details of engagement and voting rights exercised. For example, when the asset management institution received a comment from a third party about a case in which little progress had been made in engagement, the institution asked itself whether it could expect positive effects from the engagement, and the institution reexamined whether the company was one in which it could expect positive changes and considered removing the company from the scope of engagement. In some cases, the institution has narrowed down the scope of engagement. Because the institution has narrowed down the scope of engagement, is often report on individual cases, and is recognize that this is a useful opportunity to have many specific discussions on individual cases.
- In particular, public pension funds compare multiple asset management institutions, and some of them make harsh comments. In this context, the asset management institution sometimes receive suggestions that other institutions are also engaged in such activities, which leads to the reinforcement of the system. In particular, suggestions from clients are easy to address, including the securing of company-wide resources.

Feedback and exchange of opinions from asset owners	[Summary] Feedback from asset owners is being provided.

(Specific examples of initiatives (asset owners))

- The asset owner exchanges opinions on the progress of engagement every quarter with the asset management institutions with whom they place emphasis on engagement. With other asset management institutions, the asset owner exchanges opinions on the status of dialogue with portfolio companies at the timing of the revision of voting criteria and after the AGM. In addition, the asset owner exchanges views on a wide range of topics, including new ESG issues, with investors, both Japanese and foreign-affiliated, who are expanding their businesses globally.
- It is necessary to have the asset owner ‘s ideas understood by the asset management institutions, and there are many opportunities for two-way communication. In some cases, meetings are held on a regular basis in addition to meetings pertaining to evaluation. When there are requests for feedback from evaluation meetings, etc, the asset owner may inform those to the asset management institution individually.

Lack of incentives

Reflection on fees

Stewardship activities reflected in fees	[Summary] The asset owners have initiated efforts to reflect stewardship activities in its fees and assessments.

(Specific examples of initiatives (asset owners))

- The asset owner has outsourced passive management with an emphasis on engagement, and the asset management institution has made a proposal that includes fees.
- The asset owner believes that serving as a lead manager in a collaborative engagement will provide expertise, knowledge, and experience, and as a result, improve our capacity for engagement. Therefore, the asset owner has added the way in which is participates in and engage in collaborative engagements to its evaluation of asset management institutions in their stewardship activities.

[Reference] Numerical Targets, etc. for Women's Active Engagement

Numerical targets for women’s active engagement

- The government, business community, investor groups, etc. have set numerical targets for women’s active engagement

Government’s Targets

The Fifth Basic Plan for Gender Equality (December 25, 2020)	➢ Create a society within the 2030s, in which everyone can demonstrate their abilities regardless of sex and gender where both women and men alike are in leadership positions; and ➢ Implement measures <u>to increase the proportion of women in leadership positions to about 30% of the total as early as possible during the 2020s</u> as a milestone.

Goals and opinions of business and investor groups regarding the ratio of female executives

Japan Business Federation (". The New Growth Strategy", November 17, 2020)	➢ Aim to increase the <u>percentage of female executives* to 30% oe more by 2030.</u> (*) Based on the officers under the Companies Act.
30% Club Japan (Inaugurated on May 1, 2019)	➢ The goal is to <u>increase the percentage</u> of women on TOPIX100's Board of Directors to <u>30% by 2030</u>.
Asian Corporate Governance Association ("Proposal to Promote Gender Diversity in TSE Prime Market Boards (Open Letter)") October 19, 2022)	➢ The following recommendations were made to increase the ratio of female directors in Japanese companies. • Changes to listing criteria for TSE Prime Market. i. If the board of directors of a newly listed company is composed solely of the same sex, the company will not be allowed to list. ii. Require the appointment of at least one female director as soon as possible and at least two female directors within a reasonable time frame, such as two to three years after that. iii. <u>Mandate the achievement of a 30% ratio of female directors by the end of the AGM in 2030</u>. • Revision of Japan’s Corporate Governance Code. i. Revise the Code to encourage all Prime Market listed companies to have 30% female directors as soon as possible in 2024, and all other listed companies to appoint at least two. ii. Revise the Code to ensure that all listed companies achieve a 30% ratio of female directors as soon as possible in 2027.

[Reference] Overview of the Revisions to the G20/OECD Principles of Corporate Governance

Overview of the Revisions to the G20/OECD Principles of Corporate Governance

Background

- In response to changes in the economic and social landscape resulting from climate change and the COVID-19 pandemic, the OECD Corporate Governance Committee initiated a review of the OECD Principles of Corporate Governance. This review was endorsed during the G20 Rome Summit in October 2021. The G20 Bali Summit in November 2022 acknowledged the progress made in this endeavor. Following public consultations held in September-October 2022, the Committee adopted the revised Principles in March 2023. The finalization of the revised Principles is expected by the end of 2023, after undergoing additional review processes including the OECD Ministerial Council, G20 Finance Ministers and Central Bank Governors Meeting, and G20 Leaders' Summit.
- The Principles of Corporate Governance are recognized as the sole international standards in the field of corporate governance, receiving endorsement from the G20 Leaders. These principles are adopted by 53 developed and emerging countries globally, encompassing G20 member countries as well as OECD countries. Moreover, the Financial Stability Board and the World Bank consider them as crucial benchmarks in evaluating the regulatory frameworks for corporate governance within the financial sector of countries.

Purpose of the revision

✓ **Improving companies' access to the stock market**

Equity markets play a crucial role in financing corporate growth and facilitating the efficient allocation of capital. Given the recent decline in the number of listed companies, it is important for each jurisdiction to make efforts to enhance companies' access to capital while simultaneously promoting investor protection and providing investment opportunities for households. Such endeavors will be supported.

✓ **Corporate governance that fosters corporate sustainability and resilience**

In response to the impact of the COVID-19 pandemic, it is imperative to establish a corporate governance framework that enables companies to adapt their business strategies flexibly in a rapidly changing environment, ensuring long-term sustainability and enhancing their overall business value.

Main contents of the proposed revision

✓ **Sustainability**

As international disclosure standards for sustainability are currently being developed, the draft revision of the Principles incorporates a new chapter, Chapter 6, titled "Sustainability and Resilience." New principles on disclosure and corporate governance frameworks are added.

✓ **Institutional Stewardship Activities**

The assets managed by institutional investors continue to grow, and in many countries, these investors hold the largest stakes in listed companies. Notably, there is an increasing trend of large institutional investors engaging in indexed investments. However, these investors often lack strong incentives to actively engage with companies. In light of this, the revised Principles provide more comprehensive guidelines on the accountability and engagement of institutional investors with corporations. Additionally, the revision includes specific references to ESG assessment and data providers..