

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

1. Date and Time: October 18, 2017 (Wednesday) 9:30-11:30
2. Venue: 13F, Central Government Building No. 7, Meeting Room No. 1

[Ikeo, Chairman]

It's already the scheduled start time, so I'd like to open the eleventh Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code.

Thank you very much for taking the time from your busy schedule. We have not met for a long time, while another council was working on the revision of the Stewardship Code. In resuming the Follow-up Council, there is a change in the members: three members newly joined the Council. I'd like to ask the secretariat to introduce the new members.

[Tahara, Director of the Corporate Accounting and Disclosure Division, FSA]

Let me introduce three new members of the Follow-up Council according to the seating order. As shown on the seating chart, from the right hand side of the members, Mr. Akiyoshi Oba, Ms. Kerrie Waring, and Mr. Hiroki Sampei.

Today, Ms. Waring, one of our members, will provide a presentation. In this connection, Mr. George Iguchi, board member of ICGN, which Ms. Waring belongs to, is also attending this meeting.

[Ikeo, Chairman]

Thank you very much. I heard that Mr. Scott Callon will join us later.

Now I'd like to move on to today's agenda. First, I'd like to ask a representative of the Financial Services Agency (FSA) to explain the progress of the corporate governance reform.

[Tahara, Director of the Corporate Accounting and Disclosure Division, FSA]

I'll explain the progress in accordance with Material 1 "Progress of Corporate Governance

Reform”. We also distributed statistics titled “How Listed Companies Have Addressed Japan’s Corporate Governance Code” as of July 2017, which was recently released by the Tokyo Stock Exchange (TSE). Please use it as a reference.

As shown in the table of contents, today I’ll explain the progress of initiatives toward the corporate governance reform, and based on that, I’ll share suggestions provided at this point.

First, I’ll talk about the progress of initiatives for achieving the corporate governance reform so far. As you know, since the establishment of the Abe Cabinet, as a part of the Growth Strategy, the Stewardship Code and the Corporate Governance Code were established, and significant efforts have been made to achieve the corporate governance reform. Focusing on increasing mid- to long-term corporate value and investment returns, thus stably growing the asset of households, this initiative aims at eventually realizing a virtuous cycle for the entire Japanese economy, and enriching the people’s life. The chart on page 3 shows such consequences.

With efforts of concerned parties, we perceive that there has been steady progress in the corporate governance reform. On the other hand, there was a suggestion that specific actions taken may not really be substantive and sufficient. Therefore, we convened the Follow-up Council meetings, asked the members to discuss how to achieve the corporate governance reform effectively, and utilized the outcome of such discussion to take necessary measures in a step-by-step manner.

Last year, under such a circumstance, we considered that stewardship activities would be the key, and the Council had fruitful discussions on this point, leading to the revision of the Stewardship Code in May 2017. Major Issues of the revision are summarized in the chart on page 4. The members reaffirmed the roles of asset owners and asset managers, and discussed how to encourage active dialogue between them and listed companies. And we reflected the outcome of such discussions in the Code.

I’ll report on institutional investors’ initiatives in response to this revision. First of all, Japanese asset managers, mainly major managers, have increasingly established a third-party committee which supervises proxy voting. Furthermore, upon general shareholders’ meetings of this year, some major asset managers started to disclose their voting records for each investee company on an individual agenda basis. Indeed, after general shareholders’

meetings, many asset managers have disclosed voting records for each investee company on an individual agenda basis (hereinafter, “company-level voting disclosure”), and we believe that such a move has increased implications.

Moreover, not only disclosing company-level voting results, some asset managers have also disclosed reasons for casting ‘for’ or ‘against’ votes. We consider this to be an indicator of increased accountability.

As for asset owners, Government Pension Investment Fund (GPIF) established Stewardship Principles and Proxy Voting Principles for contracted asset managers in June 2017, giving directions on how to conduct stewardship activities.

In addition, GPIF requires contracted asset managers to disclose voting records for each investee company on an individual agenda basis. In that light as well, we perceive that both asset owners and asset managers have been increasingly working on stewardship activities, and that would be the outcome of discussions at the Follow-up Council.

Page 6 shows a specific example of company-level voting disclosure by the Sumitomo Mitsui Trust Bank for your reference.

Now I’d like to explain the section titled “Pending Issues about Corporate Governance Reform” from page 7. Please turn to page 8. Since the establishment of the Abe Cabinet, various efforts have been made for the corporate governance reform. We have received various suggestions so far. While the Follow-up Council had a recess, we talked with various people, and most common suggestions can be classified into these five points.

The first point is about investments and internal reserves. It was pointed out that, as a result of working hard on the corporate governance reform, companies seem to have increased their internal reserves in the form of cash and deposits. Meanwhile, some questioned whether companies have invested enough in their equipment, human resources, and R & D.

The second point is about management decisions in response to changes in the management environment: this point refers to the background of the first point. The corporate governance reform focuses on increasing mid- to long-term corporate value, but various people expressed their doubts about whether the Reform has really been implemented in a way to ensure that corporate managers make good management decisions. In particular, many people pointed out that the management may not be sufficiently conscious of the capital cost.

In this connection, the third point is about CEO and Board of Directors (“board”), on which the Follow-up Council had extensive discussions to identify problems from the perspective of corporate governance. It was pointed out that CEO and the board have not taken sufficient initiatives, or that outside directors have not effectively fulfilled their responsibilities.

As the fourth point, it was pointed out that cross-shareholdings have not sufficiently been reduced.

The fifth point. The Council discussed stewardship activities last year, and the Stewardship Code was revised to enhance stewardship activities. However, it was pointed out that especially asset owners seem to lack aware of their fiduciary duties or stewardship responsibilities.

Now I’d like to explain details of these five points, as shown on page 9 and thereafter. As for the first point about investments and internal reserves, as you know, companies have retained earnings: cash and deposits surged more than 200 trillion yen, and are still increasing.

Meanwhile, while equipment investments in the United States increased approx. 2.5 times of the 1995 level, such investments in Japan have remained almost unchanged. Furthermore, the labor’s share has been somewhat in a downward trend. Similarly, in terms of R & D expenses, as shown in the comparison between 2011 and 2016 on the right-hand side of page 10, although six Japanese companies were ranked in the global top 30 in 2011, the number decreased to two companies in 2016. Based on these facts, some expressed their doubt about whether Japanese companies are taking a positive stance toward such investments.

From page 11, we quoted results of the survey by the Life Insurance Association of Japan. Investors perceive that companies’ cash on hand exceeds an appropriate level. According to the survey result shown in the upper chart, many investors consider that levels of cash on hand are ample. On the other hand, roughly 60% of companies consider that their cash on hand is at an appropriate level. In addition, as shown in the lower chart, roughly 60% of investors replied that they would like companies to use such cash on hand for investments in future growth.

Under such circumstances, how do companies determine an appropriate level of cash on hand? As shown in the chart on page 12, roughly 50% of companies have such guidelines as ratios to sales, profits, working capital, or cash flows, etc. In the meantime, approx. 30% of

companies replied that they do not have any specific criteria.

Furthermore, while approx. 50% of companies replied that they set a certain level as a guide, nearly 70% of investors feel that companies have not provided sufficient explanations or hardly provided any explanations about such a level. We consider that the challenge is how to fill such a perception gap through dialogue.

Next, I'd like to explain the second point: management decisions in response to changes in the management environment. We understand that individual companies have made various efforts, yet we summarized common issues raised mainly by foreign investors. As shown on page 13, net income of Japanese companies hit a new high, but it was pointed out that while such indicators as ROS, ROA, and ROE have shown an upward trend, the levels are far below those of the United States. Especially, PBR has remained at around 1.0 time in the past several years, and the most recent record shows that companies with PBR below 1.0 time accounted for one-third of all companies.

What do investors think about in such a situation? According to the survey by the Life Insurance Association of Japan again, many investors expect companies to select and focus on certain business lines: as shown on the chart on page 14, more than 70% of investors replied that they are looking forward to seeing that. In contrast, companies that place an emphasis on that area accounted for merely 30%. Instead, many companies replied that they focus on the expansion of their business scale and share, or cost reduction. On the other hand, investors are not expecting much in such areas, on which companies place an emphasis.

Furthermore, concerning the relation between such capital cost and return, almost a half of the companies consider that they gained returns exceeding capital cost. On the other hand, roughly 60% of investors perceive that companies failed to gain return exceeding capital cost. Again, we consider that companies and investors need to have dialogue regarding this gap.

The third point is related to corporate governance, specifically CEO and the board. Many people referred to the fact that the number of companies which appointed independent directors has been increasing. Among companies listed on TSE First Section, the companies which appointed at least two independent directors account for more than 90%; and in more than one-third of companies listed on TSE First Section, at least one-third of board members are independent directors.

Furthermore, companies have enhanced their governance by establishing nomination committee and remuneration committee, although the majority of them are on a voluntary basis: more than 30% of companies listed on TSE First Section, and almost 60% of JPX-Nikkei 400 companies have such committees. It can be said that their governance structures have been improved.

Please turn to page 17. Companies, which have in place policies for appointment or dismissal of senior management, still remain a minority on the other hand. Companies, which monitor their succession plan, account for roughly one-fourth. Furthermore, it was pointed out that the content of such policies and plans still has plenty of challenges.

The Council had extensive discussion on these points, and published its Statement in February, 2016. We still have the same concerns. Taking into account the progress since then, we consider that the Council once again needs to discuss how those recommendations can be effectively implemented.

Now I'm moving on to the fourth point about cross-shareholdings. In this regard, four major banking groups have disclosed their reduction targets and steadily reduced cross-shareholdings from the perspective of risk management as well.

However, as shown on the upper left chart on page 20, many people pointed out that the level of cross-shareholdings between business corporations remains high on a holding body basis. As pointed out by members of this Follow-up Council as well as the Council of Experts on the Stewardship Code, as shown in the upper right chart of shareholder composition, while the percentage of institutional investors, including foreign investors, has increased, the percentage of such cross-shareholders as the Government, insurance companies, banks, and business corporations, has not so declined. Many people expressed their concerns that such a situation may cause the management to lose good sense of tension. As shown in the lower left chart representing the result of the survey for corporate practitioners, in many companies, almost a half of their shareholders are expected to support the companies. On the other hand, as shown in the lower right chart, statistically, it can be said that companies with large cross-shareholdings record lower ROE. In this light, it was pointed out that such companies have to thoroughly address the issue of cross-shareholdings.

Again, the Follow-up Council discussed this issue two years ago, and we still have the same

concerns. Taking this situation into account, we'd like you to discuss the issue once again.

Finally, I'll explain the fifth point concerning asset owners. Although asset owners have steadily increased level of awareness of their fiduciary duties or stewardship activities, as the data on page 22 shows, it was often pointed out that the awareness level among corporate pension funds is still far from high.

From last year to this year, the Ministry of Health, Labour and Welfare and the Pension Fund Association also established study committee to convince corporate pension funds to accept the Stewardship Code. Unfortunately, no fund has newly accepted the Code.

While there are approx. 800 fund-type employees' pension and defined benefit pension plans, only seven pension funds have accepted the Stewardship Code so far. Besides, the corporate pension funds which accepted the Code generally belong to financial groups, and the number of pension funds under business corporations is only 1. Many people expressed their concerns about such a situation of asset owners. We'd like you to have your opinions about this issue.

On the last page, we quoted an excerpt from "the Investments for the Future Strategy 2017" which was approved by the Cabinet in June 2017. We are supposed to discuss these issues so that concerned parties will work on achieving mid- to long-term growth of the companies as well as asset growth of households. We'd like you to actively discuss these issues. That's all the explanation from me. Thank you.

[Ikeo, Chairman]

Thank you very much. We will have a discussion session after the next presentation by Ms. Kerrie Waring from the International Corporate Governance Network (ICGN), an international association of institutional investors. Ms. Waring will make a presentation in English, and consecutive translation service will be provided.

Now I'd like to hand it over to Ms. Waring.

[Waring, member]

I would like from the outset to acknowledge the very good work that is being undertaken by the FSA. The Global Governance community is extremely impressed with the level of

progress in Japan, and we would very much like to put that on record.

I would also, of course, like to acknowledge our former board members Yoshiko Takayama, George Iguchi who is a current board member, and Ryoko Ueda who is on our Shareholder Responsibilities Committee. I am very grateful for their support.

So, as the third largest economy in the world, Japan is of course a very important market for ICGN members. My remarks will follow on some of the points that Tahara-san has introduced. Specifically, I would like to refer to capital efficiency, this issue around cross-shareholdings and the role of independent directors.

Please refer to page 4 in the PowerPoint presentation. ICGN notes the progress that has been made since the minimum target of 8% return on equity was introduced in the Ito Review in 2014; however, as Tahara-san notes, ROE in Japan is still many times lower than the U.S. or Europe.

The very first principle in the ICGN Global Governance Principles states that the role of the board is to guide, review, and approve the company's mission and purpose, its corporate strategy and financial planning, including major capital expenditures, acquisitions, and divestments. ICGN members recognize that targets such as the Ito Review are important, but we want to have a discussion around how the targets are being met. Not just about the number.

Therefore, it would be helpful if Japanese boards could provide better disclosure to shareholders on the company's capital policy. We need companies to reduce cash holdings, accelerate investments in research & development, and invest in human resources to be truly competitive on a world stage.

Global investors want to engage boards on future risks and opportunities to enhance earnings power and were talking about growth, efficiency, and profitability in particular.

Please turn to page 5. In terms of the role of independent directors, ICGN welcomes the increase of independent directors on boards, and we believe that companies should strive for one-third independent or have a minimum of 3 as it would then be possible to have fully independent nomination or remuneration committees.

But again, we need to move our focus away from the numbers and think more about the competence and effectiveness and support that independent directors need. They play a



crucial role in constructively challenging management, and they are free from external influence. They can help offset the domination of decision-making by any single individual such as the CEO or the president and then by drawing on their personal capacities, experience, and competence, they can truly contribute a diverse perspective to generate healthy debate in the boardroom.

Please refer to page 6 regarding CEO selection. It's not unusual for a CEO to be involved in setting the competencies, the strategic needs and skills sets required of a successor. However, what sets Japan apart from other markets is almost complete lack of consultation with independent directors on the actual decision of appointing the successor and also a lack of seeking advice from external recruitment consultants.

It is worth noting that CEO tenure in Japan is notably shorter than it is in the U.S. Here, I think it's about 4 years. The U.S. is 10 years. This does help to offset any form of entrenched decision-making. However, ICGN would encourage wider use of nomination committees comprised solely of independent directors.

Please refer to page 7 regarding nomination disclosure. Simply, it might be helpful to encourage companies to provide better disclosure in English around the process for CEO selection and also the selection of independent directors. This could include the rationale for appointment, core competencies, and factors affecting independence.

With regards to independence, please look at page 8. Perhaps it would be useful to include a definition of independence. In the Corporate Governance Code itself, whilst I recognize it does exist in the listing rules, we might think about expanding the factors that are deemed to impact independence such as cross-shareholding partners, major client relationships, and family ties.

Please refer to page 10 on communication. Perhaps we could encourage boards to appoint an independent director to be specifically responsible for engaging with shareholders and to encourage companies to disclose what efforts they themselves are taking to engage with investors. ICGN members are particularly keen to engage at board level.

Please refer to page 11 regarding induction. So, it might be helpful to provide more induction and training for non-executive directors, but also for executive management, so that the managers understand the value of having a collective board comprised of independent

directors.

Financial literacy is particularly important to ensure that independent directors are able to challenge management on issues such as capital efficiency, the use of cross-shareholdings, and the issuance of shareholder rights plan or poison pills.

Please refer to page 12 regarding board evaluation. The outcomes from a board evaluation will help to inform the types of candidates of strategic relevance to the company. We stress the importance of having a board evaluation conducted externally at least once every 3 years, and this process for the evaluation and any material issues of relevance really should be disclosed to shareholders.

Please refer to page 13 regarding cross-shareholdings. The practice of cross-shareholdings amongst the business community in Japan really is a major concern to ICGN members. The perception here in Japan seems to be that it is essential for business relationships, whereas sentiment from the global investment is very different, and I have a number of examples of the concerns as follows.

Concerns include obstruction to fair competition, unreasonable restraint of trade, unequal treatment of shareholders, inappropriate use of anti takeover measures, inefficient capital management, obstruction to board independence, and ineffective managerial challenge.

Please refer to page 15. Regarding managerial challenge, there was an interesting paper posted on the Harvard Law School forum recently in which the authors found that managers of companies with a high proportion of cross-shareholdings avoid making difficult decisions or risky choices. They also found that monitoring by investors and independent directors mitigates these effects.

ICGN recognizes that progress has been achieved by major banks in setting targets to reduce cross-shareholdings following encouragement by the FSA. However, we believe that further measures might be helpful to expedite the unwinding of cross-shareholdings in banks and across the corporate sector more generally.

Please refer to page 16. Specifically, we refer to company compliance with principle 1.4 regarding cross-shareholdings of the Corporate Governance Code. A number of ICGN members opine that disclosure provided by boards is inadequate and fails to describe an appropriate rationale for cross-shareholdings.

Please refer to my final slide, page 17. ICGN encourages Japanese companies to commit to a target to reduce their cross-shareholdings over a specified period of time. We believe that boards should justify what the business benefits in a financial sense are for having cross-shareholdings and disclose this in a form of maybe a cost benefit analysis.

Additionally, we suggest that companies should disclose the top 30 shareholdings by value as well as by the total number. Not only in YUHO, the Japan's securities report, but also on the company's website in English. I think this would help provide greater transparency around progress being made and identify more clearly which companies are dominant in this practice.

I provide further recommendations for your consideration in the annex and welcome any questions you might have on my remarks. Thank you.

[Ikeo, Chairman]

Thank you very much.

Now I'd like to open a discussion. Mr. Toyama is absent today, but he submitted his opinion statement. You can find it in the package of reference materials – probably, the last one. Although I won't introduce what is written there, please also refer to Mr. Toyama's opinion statement.

If you have any questions for Ms. Waring, you can ask questions either in the Japanese or English language. If you ask questions in Japanese, they will be translated into English. You may also ask questions in English: in that case, questions will be translated into Japanese so that they can be shared with the audience. So you can speak whichever language you feel comfortable with.

Now I'd like to hear your comments. Anyone can start a discussion. However, to ensure that everyone has an opportunity to express their views, please do not take too much time. Who would like to start?

[Oguchi, member]

Thank you. Since nobody volunteered, I'll open a discussion. This is the first meeting of the Follow-up Council after a long break, so I'd like to express my perception of issues,

specifically three points, to be discussed at the Follow-up Council from now on. The first one is the perspective of ‘growth-oriented governance’ representing the offensive side of governance; the second one is the perspective of ‘defensive governance’; and the last one is cross-shareholdings, as Kerrie also mentioned. The last one was discussed at the third meeting of the Follow-up Council, but is still pending. I’d like to talk about these three points.

Today, copies of the Corporate Governance Code and the Stewardship Code were distributed to the participants. As shown on the cover, the subtitle refers to sustainable corporate growth. The preambles of both Codes conclude by referring to the development of the Japanese economy as a whole or the contribution to the growth of the economy as a whole. Therefore, I personally believe that these are the objectives of both Codes, and the contents of the Codes are the means to achieve the objectives.

In this light, Paragraph 7 of the Preamble to the Corporate Governance Code discusses ‘growth-oriented governance’. Specifically, it reads, “[The Code] does not place excessive emphasis on avoiding and limiting risk or the prevention of corporate scandals. Rather, its primary purpose is to stimulate healthy corporate entrepreneurship, support sustainable corporate growth and increase corporate value over the mid- to long-term.” Today’s Material prepared by the secretariat summarizes suggestions or issues raised on page 8: for example, definitive management decisions have not really been made or cash and deposits have not been used for investments in facilities, research & development, and human resources necessary for sustainable growth. In my opinion, such comments indicate that, ‘growth-oriented governance’, which is the objective of the Corporate Governance, has not sufficiently been realized, despite various positive changes.

Looking at the latest economic indicators, GDP growth rate during the April-June quarter was 2.5% p.a., recording six consecutive quarters of growth. As for the GDP gap or output gap, which is one of the Government’s four criteria for judging an escape from deflation, the Cabinet Office, following the Bank of Japan, announced that demand has been surpassing supply since October 2016. Once demand shortage – the initial problem – is resolved, the next challenge lies in the supply-side.

How can we increase the growth potential of the supply-side under such a circumstance?

The current percentage is estimated at around 1%. When we break it down into labor input growth, capital input growth, and total factor productivity growth, assuming that the labor input growth is inevitably limited in countries like Japan, there would be no choice but to increase total factor productivity. After all, in Japan, healthy entrepreneurship advocated by ‘growth-oriented governance’ will be the source of innovation and increased Total Factor Productivity, thus enhancing growth potential.

While the GDP gap has been reduced, it is necessary to have in-depth discussion to stimulate healthy entrepreneurship. Therefore, now is the time to address such issues as (1) and (2) on page 8, as pointed out earlier.

I just discussed the offensive side of governance. Meanwhile, ‘growth-oriented governance’ and ‘defensive governance’ are two sides of the same coin. Precisely because companies have a brake – ‘defensive governance’ – to prevent them from running out of control, they can press on the accelerator of ‘growth-oriented governance’. I would say, unfortunately, recent headline-making corporate scandals highlight again the necessity of implementation of these principles in Japan.

I feel that the world is carefully watching Japan to identify its substance under such a circumstance. Although I won’t discuss details today, suggestions concerning defensive governance are not included in the list on page 8. As mentioned in Mr. Toyama’s Opinion Statement as well, to promote ‘growth-oriented governance’, I believe that we need to consider the strengthening of ‘defensive governance’ in parallel.

Finally, I’d like to discuss cross-shareholdings. In the first place, with regard to the Codes, the main idea of ‘Comply or Explain’ would be the promotion of autonomy. However, I realized that there are problems that cannot be solved solely through autonomy. Cross-shareholding would be one of such problems. Specific points at issue were discussed at the third meeting of this Follow-up Council, and the unwinding was discussed by the Council on Investments for the Future as well. Kerrie also made several suggestions earlier today.

In this way, points at issue are widely recognized. Then why don’t they reduce cross-shareholdings? I assume it is because there should be strong incentives for issuing companies to make certain companies hold their shares as cross-shareholders. I have had

opportunities to discuss various things about the Corporate Governance Code with corporate executives. One chairman told me that there is only one principle, which does not allow a company to decide by itself, among all 73 principles, and that is Principle 1.4 concerning cross-shareholdings. He said that there is a counterparty involved, and therefore, unless working with the counterparty, cross-shareholdings cannot be unwound. Frankly speaking, I think that there would be a limitation for further reduction only by the 'Comply or Explain' for Principle 1.4 which Kerrie referred to earlier.

So let me repeat what I mentioned at the third meeting of this Council. Although there are various views, I suggest that it should be necessary to require them to disclose their proxy voting records for each listed company on an individual proposal basis, regardless of whether shares are held as cross-shareholdings or purely for investment purposes. Various side effects or adverse effects have been pointed out concerning such disclosures. Yet, in response to discussions of the revised Stewardship Code, institutional investors moved toward disclosure of their voting records for each investee company, resulting in increased transparency and positive effects. As Principle 4.5 of the Corporate Governance Code stipulates fiduciary responsibilities of directors and *kansayaku* (corporate auditors) of listed companies to shareholders, I believe it is reasonable that companies disclose their company-level voting records to shareholders to whom they have fiduciary responsibilities as well as other stakeholders.

Some question whether there is any meaning in disclosing their voting records when they voted 'for' all the proposals. However, disclosing companies also have their own shareholders including institutional investors. Such shareholders cast votes 'for' or 'against' the companies' proposals. Disclosed voting records may highlight a difference in views between the disclosing companies and their shareholders including institutional investors. Then, I expect that voting behaviors which have no rational reason will be reduced, or if there are any reasons for such behaviors, they will have no choice but unwind cross-shareholdings.

I think we will discuss this topic in future, not necessarily today, but I'd like to recommend to include company-level disclosure of voting records as a countermeasure against cross-shareholdings. That's all.

[Ikeo, Chairman]

Thank you very much.

Mr. Tsukuda, please.

[Tsukuda, member]

Thank you. Kerrie, thank you very much for your great presentation. I have some questions to you. On page 18 of your presentation material, the second bullet point refers to CEO succession to chairman, describing that a company's retiring President should not remain on and chair the board. When we look at the reality of Japanese companies, there are cases where former president became chairman of the board, and there still are many cases where incumbent president chairs the board.

As a fact, Japanese companies do not necessarily ensure the separation of oversight and execution. What is ICGN's view of such a state? This is my first question.

The second question. In the meantime, even though we say that oversight and execution should be strictly separated, we need to consider the company size and other factors. For example, there are various recommendations: at least one-third of the board members or at least three members should be outside directors; or the board evaluation by a third party should be conducted in every three years. Yet we need to consider such recommendations from the viewpoint of proportionality. Specifically, depending on the company size, such requirements should target only companies exceeding a certain threshold of the size. Personally, I believe that such a way of thinking should be introduced in the future. Kerrie, what do you think about such a way of thinking?

I'd like to ask these two questions. That's all.

[Waring, member]

Thank you for the very good questions. On the first point about the role of CEO and chairman, this really is corporate governance 101. It's the first most basic point of governance. I think if Sir Adrian Cadbury was with us today, and he said this to me once.

He said on this point, "Just ask the chairman and the CEO, what is your job description as a chairman and what is your job description as a CEO?" Adrian said that the role of the chairman

is like being a captain on a ship, and a captain on a ship steers the boat. Over stormy waters sometimes the board has to tilt the boat here and there, but it's the management of the company who is responsible for the executive direction of the company. The role of the board is to direct, and the role of the management is to run the business. If it's combined in one individual, that clearly creates problems primarily around the entrenchment of power in one individual.

In terms of the issue of proportionality, perhaps controversially, my personal opinion is that a fully independent board is actually not helpful because you are reliant on information asymmetry from the all powerful CEO whilst the rest of the board lacks that level of access to information.

I might be biased, but I like the UK approach. We have three or four executives, six or seven independent non-executives, and may be two non-executives. Non-executives independence on executives and that for me, I think, is a good balance.

And finally, the UK code does allow for the size of company. So, there are exceptions for below 350 companies and perhaps that's something that the Japan code might consider in terms of the number of independents.

[Tsukuda, member]

Thank you very much.

[Ikeo, Chairman]

Professor Kawakita, please.

[Kawakita, member]

Mr. Oguchi earlier talked about 'growth-oriented governance' and 'defensive governance', so I'd like to share my views on them now I won't talk about things other members are likely to say. Let me just talk about something which is unlikely to overlap with other members' comments.

One is about defensive governance. In case of company T, aside from alleged insider trading, I consider that its risk evaluation/management was very weak, although there may



have been many other problems. A conclusion drawn from this case would be that, in many companies, the board alone may not have sufficient expert knowledge or expert perspectives. So it is suggested that the board should include external consultants, but such an effort tends to be halfway.

Then, perhaps in case of large companies, when they make significant decisions, including M&As, they establish an internal organization for risk evaluation/management, and ask its opinions. External experts may join such an organization, and its opinions are reported to the board. I believe that companies should have such a brake. This is the first part.

Another part is an engine. From the perspective of 'growth-oriented governance', naturally, as explained [by the secretariat] at the beginning, there is a concern that the management is not sufficiently aware of capital cost, on the one hand. However, speaking from the standpoint of the management, aside from their capabilities, I assume that such factors as morale of or incentives for the management also matter.

Frankly speaking, among board members, especially among the members here, many of them work for the society or justice, but it is also true that not a few members consider that remunerations matter, taking a stance that it is enough to work to the extent of remunerations. I think the level of remunerations in Japan is too low. After all, due to the lack of incentives in the form of remunerations, they usually try to serve out without making any serious mistakes, or remain in the position for a long period, avoiding exerting any real influence. I don't think that the Council can suggest a raise of remunerations. However, Japan should create a social environment where board members can be proud of a high level of remunerations.

Of course, an excessively high level would be problematic, but it is also problematic that the lack of such an environment results in criticism of board members who receive remunerations of 100 million yen or more.

Next, I'd like to talk about indicators of the management efficiency. I hesitate to say this in front of representatives from the Ministry of Economy, Trade and Industry, but I believe that it is problematic to measure it by ROE. As the secretariat explained earlier, the weakness of Japanese companies lies in ROA or ROS being too low. This would be a matter of management, and something should be done about that. I believe that the low level of ROA

or ROS is the cause of the gap between PBR levels in Japan and the U.S., as shown on page 13 of the material.

In this regard, companies have a lot of cash on hand, and people criticize that. Such a criticism can be understood. However, when I discussed this issue with an executive of an excellent company in Kyoto, he referred to the situation during the Lehman Shock, and mentioned that they cannot rely on banks. Companies have a strong feeling of distrust towards banks. That is an incentive for Japanese companies to have cash on hand.

Again, I hesitate to say this in front of ex-bankers, but as is often said, banks do not help companies when companies have a hard time. Such culture should be changed. Banks should have screening ability in a real sense, and make such judgments that this company will not go bankrupt, so we should help the company in its hard time. Banks would be one of significant stakeholders, and therefore, the banks' perception would be also important.

As for cross-shareholdings, I suppose this Council will discuss the matter some other time, so I'll express my view then.

[Ikeo, Chairman]

Thank you very much.

Mr. Iwama, please go ahead.

[Iwama, member]

I have a question for Kerrie. Thank you very much for your presentation. My question is very simple. It is about the communication as written on page 10 of your material. Earlier today, the FSA representative reported on the progress of the corporate governance reform. I think we share the same perception that Japan's corporate governance reform is currently in the process of development.

Various things are underway, on the basis of established governance structures. Especially, we cannot compare Japan's situation directly with that of the UK or the U.S. We should just try to lead the efforts in an appropriate direction. To realize sustainable corporate growth, collective efforts, rather than confrontation, are required.

Then, discussion starts from whether or not boards include independent directors. We

should provide some mechanism to make dialogue between companies and shareholders/investors effectively work. I think things will ultimately move in this direction. Anyway, if we go through incremental improvement, what would you advise us? This is my question.

[Waring, member]

Let me say how again impressed we are with the level of progress that is taking place. There is a mechanism and again, I refer to Adrian Cadbury, the masterstroke, the reason why corporate governance worked so well in the UK, is because of comply or explain. I think we need to educate companies and investors here in Japan what we really mean about comply or explain.

The stewardship code and the Corporate Governance Code are like yin and yang. The Corporate Governance Code requires companies to explain any deviations, CEO, chairman, so we would expect to see an explanation why it is reasonable for CEO to become chairman, what is the reason for that. It's okay to explain.

Then, the stewardship code requires investors to really read that explanation, think about it, and then make a voting decision based on their judgment of the explanation.

My impression in Japan is the explanations are maybe a bit boilerplate, and I really believe that companies and investors have the same objective to protect and enhance value over the long-term for all of us; pensioners, savers; we are in it together and so we need to bring the business and investment communities together with the organizations around this table, maybe with ICGN and the FSA, to enhance the understanding of how stewardship and corporate governance work together.

[Ikeo, Chairman]

Thank you very much.

Mr. Kawamura, please go ahead.

[Kawamura, member]

Kerrie, thank you very much for your presentation. I agree with you on most of the parts,

but I think I should make a comment on your assertion that former presidents/CEOs should not chair boards, referring to Japan's circumstances. In other countries, presidents are professional: people from various companies suddenly join and become presidents of companies, and walk away soon. Therefore, in other countries, especially in the U.S., there are few cases where retiring presidents become chairpersons of boards. I think that's true.

In Japan, presidents are often appointed from those who worked for the companies for a long time. Therefore, after retiring from the position of president, they conduct certain activities as representative of the brands. Such cases are very common in Japan, I think. Accordingly, although I'm wondering how to deal with a real case, while retiring presidents have such an important role in acting for other companies as outside directors, they also have various roles for the succession of brands of their own companies.

Although they do not intervene in day-to-day management, they remain in boards, and work on external affairs by securing such a foothold in the companies. In many Japanese companies, retiring presidents play such roles in the capacity of board chairperson. If a retiring president cannot become a chairperson, that person is considered to have some faults in the Japanese society. Even if a retiring president has achieved extraordinary business results, if he/she leaves the company without becoming chairperson, he/she has some faults. It's a shame.

Instead, it is common in Japan that retired presidents remain in the company as chairperson, without being involved in day-to-day business execution. In this context, my question is how we could explain such Japan-specific circumstances to foreign institutional investors and convince them – whether we can gain their understanding. That's what I would like to ask you.

[Waring, member]

We respect the cultural way of leadership in boards in Japan, and as I said earlier, my understanding is that 10-year is shorter. Therefore, there is a general rationale for why the CEO and chairman succession occurs and maybe simply explaining to shareholders as you have just done, why it is important for this company in Japan to have the CEO become chairman, then that will build a greater understanding amongst the global investment

community. Perhaps it's back to the point about the role of the chairman is only to facilitate effective board discussion. That's it. He is not there to influence and ultimately decide on things.

But there is a perception whether it's true or not that there is a dominant power on boards in Japan and maybe it's to do with *Komon*, the advisor system as well, which I haven't talked about. But there is a concern that there is a dominance of power within one or two individuals on corporate Japan boards and maybe...

But perhaps the answer is more independent directors and having one of the independents be the lead to talk to the investors. That's what they want. They want an engagement point. In the UK, it's normally with the chairman. In the U.S, that's not the case. Every country is different. But if you have a lead independent director who is your focal point, that might help alleviate concerns amongst global investors around the decision making processes on the boards. Thank you very much.

[Ikeo, Chairman]

Thank you.

Mr. Sampei, please go ahead.

[Sampei, member]

Thank you. I'd like to thank Ms. Waring for her presentation. I'd like to talk about some points I agree with, and make additional comments in that connection.

First, on page 8 concerning outside directors, she suggested that three factors should be added to the criteria of independence in TSE's Listing Rules. I agree with that, and suggest that major lenders should be also added [to relationships that need to be disclosed]. Outside directors from large lenders are highly likely to have conflict with general shareholders, so they could be included in the [disclosure] requirements.

I'll try to make it concise. The next point is induction on page 11. I think this is also very important. Let me share what we have felt when we actually met with independent directors: as a general tendency, there are some people who had been serving as outside directors since before the implementation of the Corporate Governance Code, yet do not seem to understand

the significance of their roles. It may be because they have never had an opportunity to participate in such kind of training or induction, I assume.

Furthermore, as we saw in the data earlier in the chart, newly appointed outsider directors are usually aware of the significance of their roles, because companies probably explained reasons for appointing or increasing the number of outside directors.

In the meantime, among outside directors since before the implementation of the Corporate Governance Code, some understand their roles quite well. In such cases, we found during the meeting with them that their companies have in place a robust training system. Therefore, I understand, from my observation, how important such induction is.

Concerning board evaluation on page 12, currently, companies in Japan conduct a series of board evaluations. In most cases, they conduct a survey in the form of questionnaire for board members. However, such survey results are disclosed in a very simple way, usually only in a few lines stating that everything has been done well. Yet some companies have made excellent disclosures.

I'd like to share an example of a company named SMC Corporation – I think it's OK to mention its name as this is a best practice.

The company has disclosed results of the survey as written by board members, though we do not understand who wrote what. Therefore, we can understand board members' responses, including their concerns and problem awareness, quite well. We can engage with the company based on such information. Although how to encourage listed companies to do so would be open to discussion, I believe that such a best practice needs to be widely shared.

Finally, I'd like to comment on cross-shareholdings on page 17. Certainly, considering the English-speaking audience, it would be a minimum requirement that companies disclose in their Securities Reports top 30 shareholdings in the English language. However, the number of cross-shareholdings is not sufficient. I'd like companies to clearly disclose changes in their shareholdings every year.

We use such disclosures for our engagement with investee companies. Once we found that a certain name of issue, which had been included in the list of top 30 shareholdings of a company in the previous year, was dropped from the list of the current year. We asked its Investor Relations (IR) Officer whether the company unwound the cross-shareholdings, and he

confirmed the unwinding. However, the following year, the name of issue was included in the list again. We once again asked the IR officer for an explanation. He said that the last year's response (stating that the name was dropped from the list due to the unwinding of cross-shareholdings – sale of the shares) was wrong. Actually, the name in question did not rank in the top 30 last year, simply because the market value declined: the company did not sell the shares, and the number of shares held remained unchanged. Such an irresponsible remark was made.

We are very much concerned about the fact that we cannot find such a mistake until after one year has passed. Therefore, we'd like the companies to make disclosures in a way to show whether there were changes in their cross-shareholdings.

In this connection, while what I just mentioned is related to Principle 1.4 of the Corporate Governance Code, I believe that disclosures under Principle 1.7 could be enhanced as well. As Mr. Oguchi also mentioned earlier, issues with cross-shareholding have two aspects: one is concerning a holding party, and another is concerning a held party. For clarifying issues concerning a held party, statutory disclosures in Japan include a section to describe related party transactions. Here, it is written that shares held as cross-shareholdings are important for business reasons. I suggest that companies should describe, in this section, how important the shareholdings are for their business/trading, and how the shareholdings are related.

Finally, with regard to capital efficiency, which is related to cross-shareholdings, when we look for causes of low ROE or low ROA, we can find various problems on their balance sheets. Taking fixed assets on balance sheets for example, while plant, property and equipment of Japanese companies have been decreasing, their working capital - cash or accounts receivables - has been increasing.

Why have receivables increased? It is because it takes much longer to collect such receivables than before. The collection period is overwhelmingly longer than that of foreign companies. Why is it so long? I assume it is related to cross-shareholdings. Therefore, it will be difficult to improve balance sheets in connection with cross-shareholdings, without shortening such receivables collection periods.

In that sense as well, accurate information must be disclosed so that we can prepare for dialogue to solve issues related to cross-shareholdings.

That's all.

[Ikeo, Chairman]

Thank you very much. I understand those were comments [not questions].

Ms. Takayama, please go ahead.

[Takayama, member]

I'd like to make two points. First, I'd like to express my impression of corporate initiatives for the governance reform since the implementation of the Corporate Governance Code. Judging from various materials distributed today, we can conclude that Japan's corporate governance reform is insufficient. Certainly, we have to admit true that there is a gap between the current state and the ideal, and many things have not been achieved.

On the other hand, focusing on changes, boards of Japanese companies have made or are making a drastic change. Due to the nature of my job, I've been involved directly or indirectly in board discussions at many companies. Since around the time when the Corporate Governance Code was established, serious discussions have been held in many companies concerning the ideal state of boards, how to separate oversight and execution, and how to define a supervisory function in the first place.

Discussions do not necessarily generate immediate results or improve business results quickly. Nonetheless, I'd like to share the fact that many changes have taken place in many companies and they are making efforts towards the reform, and I believe we should evaluate it properly.

Yet, the degree of the reform is still insufficient, this is certainly true. Then how can we accelerate the reform? Of course, companies' own efforts are important, but investors' engagement with companies would be also very important. I heard from several companies that among dialogues between investors and companies, there certainly are very fruitful and substantive dialogues, but there also are non-fulfilling, empty dialogues: the quality of dialogue largely varies depending on investors.

However, this year's revision of the Stewardship Code created a framework that requires investors to engage with companies more responsibly, so I'd like to expect a change or



progress in the future.

My next comment is about the separation of execution and supervision, as Kerrie mentioned and other members also discussed. I'd like to talk about the separation of board chairperson and CEO, or the necessity of board chairperson being an outside director. I understand that appointing a chairperson from outside directors is the top priority governance issue and important, as Kerrie mentioned.

On the other hand, although this is the top priority issue, this is also the most challenging area of governance, as a matter of fact. In the UK, because the code stipulates that board chairpersons are usually outside directors. In the U.S., as there is no such requirement, among S&P 500, companies with chairperson being outside directors currently account for roughly 30%.

However, the percentage was roughly 10% a decade ago, so there is a growing tendency that an outside director chairs the board. Yet, in the U.S. and maybe in other countries, that is a very challenging area, and every company is struggling with it. Meanwhile, in the U.S. for example, even though a board chairperson is CEO instead of an outside director, the percentage of outside directors in the board exceeds a certain level, so the independence of the board is secured. Besides, as Kerrie mentioned, there is a lead independent director. In other words, even if the board is chaired by CEO, the board composition offsets such a negative factor.

Considering this issue in the current circumstances of Japan, though an outside director is ideal to chair the board, I recommend to take a step-by-step approach, starting from ensuring that outside directors account for a certain percentage of board members.

In that context, as shown on page 5 of Kerrie's material, at least one-third of independent directors or a minimum of three must be included among the members. The said figure and percentage have reasonable grounds. As far as I know, as a result of discussions about governance in the U.S., Europe and Asia over the past few decades, to ensure the effectiveness of the board's oversight function, and provide the foundation for outside directors to make full use of their abilities, they adopted a rule of thumb: the figure "three (3)" is extremely important.

Of course, Substance is more important than Form, but it would be necessary to have

minimum Form to secure Substance. In that light, we should keep in mind such figures as one-third or three members, when we consider Japan's governance, especially the board effectiveness, in the future.

[Ikeo, Chairman]

Thank you very much. Please note that we have less than 20 minutes left for discussion.  
Professor Kanda, please.

[Kanda, member]

Thank you. Today I heard about the progress of the corporate governance reform, and felt that pretty good progress was made. I'd like to make two points to note in brief for future.

First, I feel that we should be conscious of target listed companies when we have discussion. Currently there are approx. 3,600 listed companies, but probably many of them are companies with a market cap of less than 10 billion yen. Furthermore, even though the company size is large, listed companies with parent companies or controlling shareholders account for more than 10%, if not 20%. If so, for example, in case of large companies with the latter feature, cross-shareholdings mean little, because they have controlling shareholders. The improvement of their corporate governance should be different from that of other companies of similar size without controlling shareholders.

Second, similarly to the first point, we need to be aware of the gap between an optimal state of each company and an optimal logic for all companies, typical companies or the average of the companies. Specifically, in general, internal reserves should be invested in growth opportunities, or return to shareholders, if there is no investment opportunity. Someone mentioned a company in Kyoto earlier, but each company has its own optimal solution. Therefore, I believe it is wrong to say they should do this and that according to a general logic among the entire spectrum of companies. It would be important to consider whether an optimal solution works well under the 'comply or explain' approach.

The same thing can be said about cross-shareholdings. Probably, holistically or according to general logic among all companies, zero amount of cross-shareholdings would be the optimal solution. However, we are not sure whether zero is the optimal solution for every

company. Similarly, as for earlier discussion on asset owners, the optimal solution, in general, would be that all corporate pension funds accept the Code.

However, when we look at each corporate pension fund, many funds are small, and many funds have not much expertise. For such funds, we are not sure whether conducting stewardship activities would be the optimal solution. For some of them, not conducting stewardship activities may make sense.

Therefore, we should discuss with awareness of the gap between general or average solutions and optimal solution for individual companies or investors. That's all.

[Ikeo, Chairman]

Thank you very much.

Dr. Ueda, please go ahead.

[Ueda, member]

Thank you. As written in the first half of the secretariat's material, today, we are expected to discuss 'growth-oriented governance', especially 'substance'. Basically, I consider that the Codes are tools, and the objective is the enhancement of value - corporate value and shareholder value.

Especially, discussion on investments and internal reserves in companies, as written in the first half of the secretariat's material is linked with that. Problems with Japanese companies would be the low level of awareness of capital efficiency and earning power. Analysis of the material shows that companies tend to generate profits by reducing cost. After all, low level of ROE would be attributable to low margin. Conversely said, that is reflected in the low level of R&D spending, and low level of distribution to employees.

Meanwhile, as for investors, the survey results show that investors want reinvestments instead of dividends. Was it communicated to the companies? Some companies are likely to have such understanding that investors are willing to receive a high level of dividends. Such misunderstanding can be solved through dialogue. Companies and investors may have failed to communicate their views to counterparties for mutual-understandings. Professor Kanda mentioned earlier this and I also reaffirmed the importance of dialogue about

company-specific circumstances and how investors evaluate such circumstances and encourage an improvement.

Next, I'd like to talk about cross-shareholdings. I've been concerned with cross-shareholdings and researching for a long time. I consider that cross-shareholdings would be an impediment to 'growth-oriented governance' or dialogue. Ideally, listed companies are not allowed to have cross-shareholdings, which cause the illiquidity of outstanding shares in the market. However, this is backed by corporate culture and commercial practices of Japanese companies, and companies have cross-shareholding partners. Accordingly, even though the ultimate goal is the elimination, in practice, they need to work on it on a step-by-step basis.

So, again, awareness-raising is necessary in this area as well. Furthermore, another issue is increase of transparency. It took roughly three months to prepare this small chart, as we had a hard time collecting information based on the public disclosure. We were also criticized that these figures do not accurately reflect the fact perfectly. In short, we cannot figure out the fact that should be a necessary basis for discussion. Furthermore, definitions, which companies decide, of cross-shareholdings and pure investments are vague, and thus we cannot identify the real fact. Therefore, - this might be a request for the FSA -, discussing ideal disclosures would lead to increase of transparency, and the increased transparency enables appropriate discussion. After doing so, if necessary, companies could explain purposes or views of their cross-shareholdings, and investors could have dialogue with them.

Discussions on cross-shareholdings tend to merely lead to a request to companies. However, why did companies go for cross-shareholdings? It would be because Japanese companies have little trust in institutional investors, though the situation has been changing in response to the implementation the Stewardship Code. It seems that companies cannot fully trust in investors concerning whether they, as counterparty of dialogue, support the companies over the mid- to long-term. In that sense, investors may be responsible for creating the current situation, too.

It is easy to tell them to unwind cross-shareholdings, and we'd like to see the elimination. However, many companies are afraid of being thrown out in the market without such support. Therefore, this issue needs to be solved through dialogue, including ways where investors

support investee companies in a stable manner.

That's all. Thank you very much.

[Ikeo, Chairman]

Mr. Takei, please go ahead.

[Takei, member]

Thank you. First, this is the third or fourth year for Japanese listed companies since they started to take necessary steps in response to the Governance Code. Roughly speaking, in the first year, they addressed the Code over several months, partly because the Code was implemented on short notice. In the second year, companies conducted board evaluations and underwent various reviews. Then, in the third or fourth year, they may feel, "We have already taken all necessary measures in response to the Corporate Governance Code."

However, although they may have established formal structures or taken formal measures, they need to enhance the substance in the third or fourth year. At this point, we have to send them a message that they should address the Corporate Governance Code in a substantive manner.

Moreover, in this context, it is not a good story if Japanese listed companies do not use their funds for investments in various facilities and equipment as well as human resources. Since the Code was issued in connection with the Japan Revitalization Strategy 2014, the Code explained that corporate governance means a structure allowing for definitive decision-making by the management, and encouraging use of internal reserves for investments in facilities and equipment as well as human resources. The Corporate Governance Code was established under these certain policy goals. Therefore, to achieve such underlying goals, in the third or fourth year of implementation, we should once again send a message to encourage companies to effectively respond to the Code.

In this connection, I'd like to refer to the current several principles of the Corporate Governance Code. For example, the issue concerning the awareness of capital cost and internal reserves would not have occurred, if they had complied with Principle 5.2 or Supplementary Principle 4.1.2 of the Code. I assume that companies formally or superficially

complied with these principles. As for investments in human resources, Supplementary Principle 2.3.1 stipulates that the board should take an initiative to deal with sustainability issues. Again, I feel that problems occurred because the companies complied with the Code for form's sake.

Concerning individual principles, it would be necessary to ensure that the companies properly understand the intention and background, and require them to enhance their explanations, making them more useful for dialogue with investors. The 'Comply or Explain' approach works only after the companies understand the original intention of the Code. I, therefore, believe we should communicate these points.

In this connection, as for issues of cross-shareholdings as well as accumulated internal reserves, one of the causes would be a defensive stance of the companies. And underlying reasons for such defense may be that they guard themselves, taking precaution against changes in various systems and rules. I remember that Professor Ikeo referred to a Sunshine Policy, when we had the first discussion for establishing the Corporate Governance Code. While the companies tend to regard the Code as a North Wind Policy, it may be more effective to promote concepts that are regarded as a Sunshine Policy.

It would be necessary to make it like a Sunshine Policy and let Japanese companies voluntarily take their coats off: once they comply with the Code, they will be aware that their voluntary responses to the Code will contribute to their sustainable growth. The more official requirements are issued, the more defensive they will become, regarding such requirements as a north wind. It would be important to reoffer such perspectives like Sunshine Policies.

The issue of independent directors is important, but an emphasis of discussions tends to be placed on independence criteria of outside directors, stating that people who fall under certain categories should not be outside directors. Although the emphasis should be placed on the positive list of requirements, in other words, criteria of effective outside directors to ensure the diversity, the current emphasis is placed on independence, or the negative list. Then I'm afraid that the companies may look at the issue from the viewpoint like a North Wind Policy. So we need to show the perspective and send a message in a way where the companies regard it as a Sunshine Policy.

Professor Kanda earlier referred to the gap between an optimum solution of the whole and

that of individuals. I totally agree with his comment. In that connection, while listening to comments by Mr. Kawamura and Ms. Waring about the separation of board chairperson and CEO, I was thinking like this. Companies and investors must share common understanding of the underlying intention of the Code, including why matters described in the Code are regarded as issues in the first place, and why the investors care about such matters, through constructive dialogue or engagement. Exactly why do long-term investors regard such things as issues? For the companies, it is the literacy improvement. If the companies have deeper understanding of the intention of each principle and why it is an issue, it may provide an opportunity to harmonize an optimum solution for the whole and for individuals, and make the 'Comply or Explain' approach effectively work. There are many areas where sufficient dialogue has not been held. By advocating mutual improvement of literacy, I expect that governance will become more effective or substantive. And that is the original intention of 'Comply or Explain'. Accordingly, to ensure the effectiveness of governance, it would be essential to once again communicate the intention of each principle of the Corporate Governance Code, promote deeper understanding among the companies, and thereby fill the gap between perceptions of the companies and the investors. That's all.

[Ikeo, Chairman]

Thank you very much.

Time is running out, so please make it concise. Mr. Uchida, please.

[Uchida, member]

Thank you. In the opening presentation, Mr. Tahara explained that companies have accumulated internal reserves in the form of cash and deposits. I know that many people criticize or point out such things. However, the data of the whole range of companies shows that it is not necessarily true. The chart on page 9 of Material 1 shows an increase in cash and deposits, as well as an increase in internal reserves. I have a chart comparing the data as of FY2012 and FY2015 in the form of the balance sheet, prepared by using the same information source.

In this chart, actually, while retained earnings or internal reserves increased by 73.4 trillion

yen in three years from FY2012 to FY2015, a total increase of such business investments as software, inventory, PPE (property, plant and equipment) and long-term equity investments for the purpose of strategic alliance accounts for 78.9 trillion yen.

So when we look at the data showing the entire picture, we cannot necessarily tell that companies have not used their internal reserves for growth investments, etc. along with 'growth-oriented governance'. We should not discuss it as a general issue. Instead, as Professor Kanda mentioned earlier, the discussion should be made on the premise that circumstances vary from company to company. Accordingly, if a company retains most of earnings in the form of cash, investors will have dialogue with such a company, or outside directors will carefully monitor such an aspect. That's how it should be.

If you mention that Japanese companies, in general, retained earnings in the form of cash, the business community will make the counterargument by stating many companies are not like that. Therefore, as this data probably includes non-listed companies, we should target listed companies first, and if necessary, divide them into certain categories, and provide suggestions or point out areas of improvement.

Furthermore, it was pointed out that the number of shares held by business corporations as cross-shareholdings has not been reduced, but I consider that the substance has been significantly changing. In the past, they used to ask their business partners to hold their shares, and to always cast votes for their proposals as stable shareholders. However, at present, the focus of cross-shareholdings between business corporations has changed from "trading" to "initiatives", I think.

In other words, their relationships have been further developed. They hold each other's shares not only to build so-called "supplier client relationships", but also to create something new through their business alliance, strategic alliance, or to establish a new supply chain. Cross-shareholdings have changed into shareholdings for such initiatives – something close to open innovation. When they plan to implement such initiatives, there would be many cases where they will not sell the partners' shares which they have held since a long time ago.

Consequently, again, we should not generalize this issue, but deal with the issue on a case-by-case basis, checking with each company to find out rationales for cross-shareholdings. I disagree with the generalization, implying that it is a fault of the entire business community.



We should discuss case by case. That's all.

[Ikeo, Chairman]

Mr. Oba, please.

[Oba, member]

As time is running out, I'll briefly make two points. The first point. As Professor Kanda and Mr. Uchida also mentioned, when we say, "from Form to Substance", we do not share the same understanding with regard to the degree of changes towards Substance. Therefore, I'd like to suggest that we should define common measures for evaluation.

They can be classified into two categories, as other members shared their views. One is macro data. Can we evaluate that the reform achieved certain progress in the timing where macro data shows a certain result? Another one is micro data. As other members pointed out, company-specific circumstances vary. As Professor Kanda pointed out, if we discuss matters in general terms, it will be difficult.

Therefore, I believe that this Council needs to sort out discussions on how to set macro KPIs and micro KPIs.

Let me share one specific example. Mr. Uchida referred to large cash reserves. The Ministry of Economy, Trade and Industry has also conducted a survey on it. Among those companies with large cash reserves, small and medium enterprises (SMEs) constitute a vast majority. That should be a point for discussion. The fact that the majority is SMEs implies that, as Professor Kawakita pointed out, they distrust banks, while they have significant transactions with banks. Such a situation should be clarified. This is my first point.

Another point is general issues. While Director Tahara from the FSA explained the progress, all issues are sorted out and presented on page 8. Each of them is not a stand-alone issue. All of them are interlinked, and that makes the issues more difficult.

Then, why is the current state accepted? Conversely, who are suffering from these issues? We need to clarify the answers. Who are in trouble with the current state? I'd like to refer to one thing other members did not mention. I believe that we should clarify the fact that these issues do not positively contribute to asset accumulation of the public. The starting point of

this discussion is increasing corporate value and accumulating assets of the public, and thus the mechanism should work effectively. This is the objective. It was clearly mentioned from the beginning.

Therefore, we should highlight the fact that the current state does not help the asset accumulation at all. I'm not sure how many non-members are here today. All of us, all of participants and audience here are shareholders, when GPIF holds that many shares. However, in reality, most of us may not be aware that we are shareholders. We should consider how to present the issues which, in fact, are directly linked with our own lives. That's all.

[Ikeo, Chairman]

Thank you very much.

Last but not least, I'd like to hear comments from Professor Kansaku.

[Kansaku, member]

Thank you. My comments are about the fact that few corporate pension funds accepted the Stewardship Code, as shown in the last bullet point about asset owners on page 8 of Material 1; as well as only seven corporate pension funds accepted the Stewardship Code, as shown in the table on page 23 of Material 1. This fact indicates that the progress is not sufficient even formally.

I believe that corporate pension funds are asset owners that fit the best in the concept of stewardship. Because they make investments from the mid- to long-term perspectives, and ultimate beneficiaries are clearly defined and limited. For the benefit of the ultimate beneficiaries, they need to increase value of investee companies and increase asset of the pension funds. In that sense, as for corporate pension funds, although the Stewardship Code is legally non-binding, I think they are expected to follow norms stipulated in the Code strongly.

On the other hand, as Professor Kanda pointed out, corporate pension funds may have their own circumstances. Unless there are reasons to consider that it is inappropriate to conduct stewardship activities, or there are no reasons to conduct such activities, corporate pension

funds should, as a general principle, conduct stewardship activities. I'd like to have discussions at the Follow-up Council, with regard to ways to convince corporate pension funds to accept the Stewardship Code and conduct appropriate stewardship activities. That's all from me.

[Ikeo, Chairman]

Thank you very much. I know you still have plenty to say, as usual, and some of you might want to speak in the second round, but it's already the scheduled closing time. So I'd like to close our discussion today.

Finally, I'd like to hand it over to the secretariat.

[Tahara, Director of the Corporate Accounting and Disclosure Division, FSA]

Thank you very much for your active discussion today. The secretariat will sort out points at issue for discussion at the next meetings.

The secretariat solicits public comments about matters to be discussed at the Follow-up Council in the future. We have provided you with a reference material on our website. We'd like to introduce your comments either in Japanese or English at this Council, as necessary.

We will contact you later for the date of the next meeting of the Follow-up Council. That's all from the secretariat. Thank you very much for your participation today.

[Ikeo, Chairman]

Thank you very much.

Now I'd like to close today's meeting. I declare the meeting adjourned.