

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

1. Date and Time: November 27, 2018 (Tuesday) 15:00-17:00
2. Venue: 13F, Central Government Building No. 7, Meeting Room

[Ikeo, Chairman] It's almost the scheduled opening time. I'd like to open the sixteenth meeting of the Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code.

We are informed that Professor Kawakita will be a little late. As other members are already here, I'd like to start the meeting. Thank you very much for taking the time from your busy schedule.

First, we have two new members joined the Follow-up Council. Let the Secretariat introduce the new members.

[Inoue, Director of the Corporate Accounting and Disclosure Division, FSA] I'm Inoue, Director of the Corporate Accounting and Disclosure Division, the Financial Services Agency (FSA), serving on the Secretariat of the Council. It's my pleasure to be working with you.

Let me introduce to you two new members of the Follow-up Council. Starting from the right of the incumbent members, Mr. Akihiro Matsuyama.

[Matsuyama, member] I'm honored to be here.

[Inoue, Director of the Corporate Accounting and Disclosure Division, FSA] Mr. Yoshimitsu Kobayashi.

[Kobayashi, member] I'm Kobayashi. It's my pleasure to be working with you.

[Inoue, Director of the Corporate Accounting and Disclosure Division, FSA] As for the existing members and observers, please refer to the List of Members of the Council, which we distributed to you.

There are some changes in the Secretariat members, but due to the time constraint, I won't introduce them. Please just take a look at the seating chart.

[Ikeo, Chairman] Thank you very much.

Next, I'd like to inform you that, from this meeting, we will use tablets, although hardcopies of today's Materials were also distributed to you. I'd like to ask the Secretariat to explain how to use the tablets.

[Morioka, Deputy Director of the Corporate Accounting and Disclosure Division, FSA] We will use tables for today's meeting. I would appreciate your cooperation.

Let me explain how to use tablets.

Please confirm that the display shows the meeting agenda, and press "Home" button on the right edge first. Then the display shows icons. Now press "Presenter" icon button on the upper left to return to the display of the meeting agenda. If you have any questions so far, please raise your hand. Our staff member will come to assist you. Is everyone all right? OK, I'll continue with my explanation.

On the upper center of the display, you see three buttons – "Personal", "Share" and "Presenter". "Presenter" button should be used only by a presenter. Use "Share" mode and "Personal" mode to display the reference materials.

If you select "Share" mode, your tablet interfaces with a presenter's tablet, and you can see what a presenter displays on the screen. So, basically, please tap "Share" button to select "Share" mode. If you would like to take a look at reference materials instead of a presenter's display, please tap "Personal" button to use "Personal" mode. You can switch between two modes by tapping "Personal" or "Share" button.

In "Personal" mode, pressing "Material Menu" button on the upper right of the screen displays reference materials, which we distributed to you in hard copies. Please use this function as necessary. Press "Return" button on the left to return to the display of Materials for this meeting. When you press "Share" button, your tablet interfaces with the presenter's tablet. Do you have any questions so far? If not, that's all about the operating method.

Now I have some announcement for the audience. As mentioned in the notification of the meeting, we do not distribute hard copies of reference materials here. If you do not bring reference materials, they are available from the FSA's website – "Materials for the Sixteenth Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code", Use your tablets or other devices to refer to them. We are also using a projector, so please look at the screen, as necessary.

If you have any opinions or comments on the use of tablets for this Council, please send them to the Secretariat. As this is the first time, we are not yet familiar with the use of tablets in this setting. Thank you in advance for your understanding and cooperation.

That's all from me.

[Ikeo, Chairman] Thank you very much. Maybe, we can figure it out only after we actually use them. Now I'd like to move on to today's agenda.

Today, after a representative of the Secretariat explains reference materials, we will discuss issues related to initiatives under the Corporate Governance Code first, and then issues related to initiatives under the Stewardship Code separately.

Now I'd like the Secretariat – a representative of the FSA – to explain today's materials.

[Inoue, Director of the Corporate Accounting and Disclosure Division, FSA] I'll explain today's topics according to Material 1 and Material 2 in your hand.

We prepared Material 3 as a reference material by compiling data corresponding to each item in Material 1 and relevant materials. Due to the time constraint, I will omit the explanation. Please refer to the material, as necessary.

First, please take a look at Material 1 "Corporate Governance Reform".

As shown in the Content, we summarized key issues in such categories as corporate governance reform initiatives, initiatives under the Corporate Governance Code, and initiatives under the Stewardship Code.

Page 3 shows initiatives taken for deepening the corporate governance reform. Two Codes, as 'the two wheels of a cart', aim at increasing corporate value and returns to households over the mid- to long-term through constructive dialogue between companies and investors from the mid- to long-term perspectives, thus a realizing virtuous cycle of the entire Japanese economy.

Next, I'll explain business management in consideration of cost of capital.

Please turn to page 5 about managing business in consideration of cost of capital. On this graph (scatter plot), dots represent companies listed on the TSE First Section, where ROE is plotted along the horizontal axis and PBR along the vertical axis. Blue dots represent those in 2014 when the corporate governance reform started, and red dots represent those in 2018. Comparing these two in terms of median values, you can see an overall increase in both ROE and PBR.

Now please look at the ROE distribution graph on [the upper half of] page 6. The blue line

shows the distribution of ROE in 2010-2013, and the red line shows that in 2014-2017. You can see an overall increase in ROE in this graph. However, while investors consider the desirable level of ROE over the mid- to long-term is 10% or more as shown in the lower-left graph, the percentage of companies which achieved such a level is still small as shown in the yellow-shaded area in the upper graph.

The pie chart on the lower right shows whether companies calculate cost of capital, based on the latest survey. The survey result found that almost 60% of the companies do not calculate the cost of capital. It has been pointed out that some companies are not sufficiently aware of the cost of capital.

Next, I'd like to explain the fulfillment of the board's responsibilities.

See page 8, and look at the graph on the left. More than 90% among companies listed on the TSE First Section currently appointed 2 or more independent directors. On the other hand, as shown in the graph on the lower left, the percentage of companies with one-third independent directors remains at the 30-percent level.

Please look at the graph on the right. The number of female officers of listed companies increased to more than 1,700 persons, and their percentage significantly increased from 1.2% to 4.1% in the past 10 years. On the other hand, as shown in the lower-right graph, approximately two-thirds of listed companies appointed no female officers.

Let's move on to page 9 about the appointment and dismissal of CEO. The revision of the Corporate Governance Code in June 2018 includes an additional requirement for setting 'dismissal criteria'. The most recent survey shows, after the revision of the Corporate Governance Code, a significantly increasing number of companies are considering setting 'appointment criteria' and 'dismissal criteria', as you can see in the graphs.

Now please see Material 3, page 13. We distributed the hard copies to the members. Under the title of "Fulfilling the board's responsibilities", the graphs show whether companies have Nomination Committee and Remuneration Committee. While an increasing number of companies have statutory or optional Nomination Committee and/or Remuneration committee, among companies listed on the TSE First Section, the percentages of companies with these Committees are still around 30%.

In this regard, the revision of the Corporate Governance Code in June 2018 includes a

stipulation that calls for establishing such independent committees as optional Nomination Committee and Remuneration Committee, comprising mainly independent directors. We expect the number of companies with such committees will further increase in the future.

Let's go back to Material 1. Now I'd like to explain the current situation on cross-shareholdings.

Please turn to page 11. The left graph indicates the percentage of institutional investors indicated by the blue line has been increasing, while the percentage of stable shareholders indicated by the green line has been gradually decreasing. As far as Nikkei 225 companies are concerned, the percentage of stable shareholders, on a voting right basis, still exceeds 30%, which is higher than comparable percentages in other countries.

Please look at the right-side graph showing cross-shareholding ratios by shareholder category. The percentage of financial institutions indicated by the red line dropped sharply in the early 2000s, and then continued to decline moderately. As for business corporations indicated by the green line, their percentage has remained almost unchanged for the past dozen years or so, and therefore, we consider that they still have a challenge.

Please turn to page 12. The FSA has been pursuing the improvement of corporate disclosures of cross-shareholdings in Securities Reports. Specifically, we are now considering the amendment of Cabinet Office Ordinance to increase the number of stock names subject to disclosure from 30 to 60, and require disclosure of purposes/effect of shareholdings, whether counterparties hold shares of the company in question, and reasons for increase in the number of shares, as shown in the right-most column in the right table. The draft amendment is currently under the public comment process, and will be applied from the fiscal year ending March 2019.

Now I'll explain "Ensuring confidence on audit".

Page 14 listed up audit-related measures for ensuring confidence on accounting measures. In response to recent accounting frauds, for the purpose of improving governance of audit firms, the Audit Firm Governance Code was established in March 2018. Then, for the purpose of increasing transparency in the audit process, audit standards were revised in July 2018. Furthermore, for the purpose of securing the independence of audit firms, the first survey report on mandatory audit firm rotation was published in July 2018.

For the increased transparency of audit reports, I'd like to provide some explanations according

to page 15. In the current Auditor's Reports, except for the representation of whether financial statements are fairly stated, descriptions of auditor's opinion are limited. In the meantime, EU, the US, and some other countries have introduced the regime where auditors describe possible misstatements and other risks, which they took note of, in Auditor's Reports.

Based on its deliberations, the Business Accounting Council revised accounting standards in July 2018: auditors are now required to describe audit risks, which they focused on in the process of accounting audits, as Key Audit Matters.

The revised accounting standards on Key Audit Matters are to be applied to audits for the accounting period ending in March 2021, and early application is also possible. Especially, companies listed on the TSE First Section are expected to apply the revised standards to audits as early as the accounting period ending March 2020.

Let's move on to page 16. As for internal audits, it is pointed out that, under the "three lines of defense" model, operation divisions as the first line, control divisions as the second line, and internal audit division as the third line need to work effectively and independently from other lines.

Especially, some point out it is important that the internal audit division reports directly to the Monitoring Board, which is a supervisory body independent from the management. In reality, as shown in the table on the bottom, in many companies, the internal audit division reports only to President/CEO. We consider that a future challenge is the collaboration between the internal audit division and the supervisory body, which is independent from the management – for example, independent directors.

Next, I'll explain the improvement of information disclosure.

Page 18 summarized the report issued by the Working Group on Corporate Disclosure of the Financial System Council in June 2018. The Group published its recommendations on the improvement of financial and narrative information, disclosure of corporate governance information to facilitate constructive dialogue, and so forth.

On the right, we described the FSA's future initiatives in response to these recommendations. In addition to the revision of the Cabinet Office Ordinance written at the bottom, as shown on the upper right, we would like to formulate principles for disclosing business strategies, MD&A and risks from the standpoint of the management as stated on the upper right, and collect and publish best practices of disclosures as stated in the middle. As for the revision of the Cabinet Office

Ordinance on the bottom right, it is currently under the public comment process. Page 19 summarized key points of the revision.

For improving “narrative information”, it is required to describe business strategies with an explanation of company’s management-level view of market conditions, competitive advantages, etc., and explain accounting estimates. For facilitating constructive dialogue, it is required to explain management’s remuneration program, and improve disclosure of information on cross-shareholdings, which I explained earlier. Furthermore, it is required to disclose activities of *kansayaku* (corporate auditors) and the tenure of the audit firm.

Please turn to page 20. We believe that narrative information is important as it complements financial information and enables investors to make adequate investment decisions, so we expect disclosures which appropriately reflect discussion from the management’s perspectives.

In the meantime, as stated at the bottom, compared to disclosures by foreign companies, we understand that disclosures by Japanese companies often lack narrative information from the standpoint of the management, or do not include sufficient segment information.

Please turn to page 21. Taking into account such issues raised, the FSA is now considering the formulation of ‘principle-based guidance’ which provides points of view on disclosure of narrative information and efforts toward desirable disclosure. As key issues for discussion on disclosure of narrative information, we presented 5 key issues – appropriately reflecting discussion from the management’s perspectives, materiality, reflecting discussion on cost of capital, segment information, and reader-friendliness – on page 21.

Specifically, as principles for facilitating disclosure from the management’s perspectives, we are considering such principles that discussions at the board of directors and/or management board on disclosures should be appropriately reflected in disclosures, and that disclosures, in terms of the order of topics and descriptions, should appropriately reflect the degree of possible impact on business results.

I’d like to hear opinions of the members about these key issues in the draft guidance later today. I’d appreciate your input.

That’s all about today’s topics related to the Corporate Governance Code.

Now I’m moving on to initiatives under the Stewardship Code starting from page 22.

First of all, please take a look at page 23 to find the current investors’ initiatives. This page is

about the current status of disclosures of voting records for each investee company on an individual agenda basis (“company-level disclosures”). As of December 2016, which was before the revision of the Stewardship Code in 2018, 15 institutions made company-level disclosures. However, as of end-October 2018, the number of such institutions significantly increased to more than 100 institutions, 18 of which disclosed reasons for voting against companies’ proposals on an individual agenda basis.

Next, page 24 is about reporting or disclosure of stewardship activities. We understand that roughly 100 institutions disclosed their stewardship activity reports. Meanwhile, as shown in the graphics on this page, while some institutions listed up names of engaged companies or examples of exercising voting rights based on dialogue, other institutions do not necessarily provide specific descriptions of their activities. Disclosed information significantly varies among institutional investors.

Taking it into account, the FSA’s proposals are presented on page 25. Currently, for institutional investors who have signed up to the Stewardship Code, the items on the left of the table are published on the FSA’s website. As the current disclosure items, a website where the announcement of the acceptance of the Code has been disclosed, a website where the disclosure items described in the Code have been disclosed, and the status of update in response to the revision of the Code in May 2018 are published.

Now we’d like to propose new disclosure items shown on the right of the table, in addition to the current items, except for corporate pension funds and institutional investors who are categorized into “other”. New disclosure items are “whether an institutional investor disclosed its voting records and reasons for casting ‘against’ votes”, “whether it disclosed its stewardship activity report”, and “website address used for such disclosure”. We suggest that such items should be posted on the FSA’s website.

With the proposed enhancement of disclosure items, we would like to encourage disclosures of company-level voting records and stewardship activity reports through these additional disclosures of the current status. We would like to hear opinions of the members on this proposal as well later today.

Next, I’d like to explain stewardship activities by corporate pensions.

Please move on to page 27. As for stewardship activities by corporate pensions, to facilitate the

performance of the investment chain, we believe it is important that asset owners urge asset managers, through encouragement or monitoring, to have constructive dialogue with companies.

As shown on the bottom of the chart, in June 2018, the Corporate Governance Code was revised by adding a new principle which requires sponsoring companies to provide support to corporate pensions in terms of human resources and administration. We expect that more corporate pensions will conduct stewardship activities, while being careful about conflicts of interest with their sponsoring companies, in response to the revision, and fulfill asset owners' responsibilities.

As you can see in the right chart, while major public pension funds already signed up to the Stewardship Code, only 14 corporate pension funds signed up to the Code.

Please turn to page 28. In the meantime, an increasing number of corporate pension funds, especially pension funds for business corporations shaded in red, have signed up to the Code. The FSA would like to work with the business community to encourage stewardship activities by corporate pension funds.

That's all about my explanation of Material 1.

OK, now please take a look at Material 2 "Key issues to be discussed at the Follow-up Council".

On this single sheet of paper, we listed up issues which the Secretariat would like the members to discuss at the Follow-up Council during this business year.

The first bullet point is about issues in consideration of responses to the two Codes. As issues related to the Corporate Governance Code, we raised such issues as "managing business in consideration of cost of capital", "fulfilling the board's responsibilities" and "cross-shareholdings"; and relating to the Stewardship Code, we would like you to discuss various issues of stewardship activities including those by corporate pension funds).

Under the second bullet point, other issues are listed up: "ensuring confidence on audit" and "improving information disclosure". The latter includes discussion on "principle-based guidance" which I explained earlier in connection with Material 1.

There should be other issues which are not included in Material 2, but need to be discussed in the future. We would like to invite the members' opinions on such issues.

That's all for the explanation from the Secretariat.

[Ikeo, Chairman] Thank you very much.

Additionally, we have received opinion statements from three members – Mr. Iwama, Dr. Ueda, and Ms. Waring – who are absent today, so, a representative of the Secretariat will briefly introduce main points of the statements.

[Inoue, Director of the Corporate Accounting and Disclosure Division, FSA] OK, I'll share the overview of opinion statements submitted by Mr. Iwama, Dr. Ueda, and Ms. Waring prior to this meeting. We distributed hard copies to the members.

First of all, Mr. Iwama appreciated the progress by stating that both Codes have gradually penetrated the entire investment chain, and engagement activities have been conducted accordingly. Then he shared the following opinions.

With regard to investors, he suggests that we should discuss measures to raise an awareness among asset owners that they are responsible for stewardship activities, and then to encourage them to be willing to sign up to the Stewardship Code.

To reduce the burden of engagement costs to passive managers, it would be important to promote the use of a voting platform. Furthermore, he asserts that collective engagement should be promoted as well. He points out that it would be necessary to educate individual investors and improve investor literacy at the individual level to gain a broad understanding of the effectiveness and importance of these two Codes.

Next, I'll summarize Dr. Ueda's opinions. After the revision of the Corporate Governance Code this year, an increasing number of companies have been autonomously implementing the Code; and engagement activities have taken root among institutional investors. She evaluates the current state in that way, and expresses the following views.

Each division has each set of values in terms of what they are aiming at, even within a single company. In the end, information disclosed tends to show mere acceptance of status quo, or to be abstract information. Therefore, she believes that a "command center" – for instance, the corporate planning division –, which directly reports to the top management, needs to lead cross-divisional discussions.

With regard to cross-shareholdings, in case companies newly or additionally hold such shares, they should be required to make enhanced disclosures; and as cross-shareholdings may hinder dialogue, disclosure of in-depth information on such shareholdings is required.

As for engagement, while business strategies and business portfolio are the core issues of corporate management, she points out that investors and companies do not usually discuss such issues, and dialogues often focus on such innocuous topics as ESG-related issues. Meanwhile, companies should explain how their sustainability-related activities contribute to increasing the mid- to long-term corporate value. Institutional investors should incorporate ESG elements and outcomes of engagement into their investment processes.

Then she supports our proposal for enhancing disclosure items on “the list of institutional investors who accepted the Stewardship Code” in the last paragraph.

Finally, I’ll share main points of Ms. Waring’s opinions. She first expressed ICGN’s compliments to the Council of Exports on the strides that are being undertaken to help enhance dialogue between investors and companies for increasing long-term corporate value of Japanese companies, and then addressed some issues.

First, with regard to the fulfillment of boards’ responsibilities, she recommends us referring to a specific time period within which corporate boards have more than one third of independent directors, for example by 2021. ICGN also suggests that a definition of independence criteria should be clarified in the Corporate Governance Code. Taking the recent Nissan’s example into account, ICGN asserts that a corporate board should be collectively responsible for corporate governance disclosures, and the board should be responsible for overseeing and approving not only Securities Reports, but also Annual Reports and other relevant disclosures. All publicly listed companies in Japan should establish Nomination Committee and Remuneration Committee, and disclose details on composition, independence and roles of each committee.

Next, with regard to the enhancement of corporate disclosures, ICGN noted that many companies only provide boilerplate explanations on the purpose of the cross-shareholdings, and supports the revision to the disclosure regulations on cross-shareholdings. While ROE for Japanese companies are improving, on a comparative basis, the profitability of Japanese companies still lags peers in North American and European markets. Japanese companies should disclose more details about cost of capital, shareholder returns, growth strategies and cash usage. Furthermore, ICGN suggests that boards should increase the proportions of women at a board level and report on progress in meeting the targets. They also state that disclosing a skills matrix pertaining to board members would be helpful.

Finally, ICGN points out that the quality of investor stewardship disclosures varies, and suggests that we should consider the tiering of signatories to the Stewardship Code similarly to what is done in the UK.

That's all for the brief explanation from the Secretariat.

[Ikeo, Chairman] Thank you very much.

Now it is time for discussion among the members.

There are [two] key areas of discussion, and I would like you to discuss them separately. First, we will discuss issues related to the revised Corporate Governance Code, as shown in Sections I and II of Material 1. Then, in the latter half of the session, I'd like you to discuss issues related to the revised Stewardship Code, as shown in Section III of Material 1.

Now let's start discussion on issues related to the revised Corporate Governance Code. I would appreciate it, if you shared your opinions on key issues of "principle-based guidance" which were explained by the Secretariat representative earlier.

Anyone can open the discussion. Does anyone wish to express views or ask questions about the Corporate Governance Code? Mr. Kobayashi, please go ahead.

[Kobayashi, member] This is the first meeting for me to attend.

I have some questions about "principle-based guidance". I'd like to confirm the use of the term. In my understanding, it should be "financial information" versus "non-financial information", but the term "narrative information" is used here [instead of the latter]. I'd like to know the meaning or implication of this term. Are you using the term "narrative information" because it refers to qualitative information? However, considering that financial information is generally expressed in figures, in contrast to that, I think the term "non-financial [information]" would be easier to understand.

There are such environmental issues as CO2 emissions, and the issue of plastic debris in the ocean facing the chemical industry. There are many such social issues, and they are risks for all industries. Naturally, they are the biggest risks for individual companies as well. I believe that discussing such issues should be "principles" in a real sense. What do you think?

In that sense, financial information just shows results over a quarter or so, and when we consider a company's sustainability – say, in a 10-year span, environmental issues or such social issues should be more important for all investors, not just institutional investors, to make

investment decisions. While the Task Force on Climate-related Financial Disclosures or TCFD is moving toward expressing environmental risks quantitatively, instead of qualitatively, in what way do you expect companies to describe the sustainability or similar topics? Unlike other management indicators like ROE and ROS, how to describe such matters may vary depending on each company's specific circumstances. Recently, a new indicator has been introduced: that is Total Shareholder Return or TSR, which is straight forward for investors to understand. Under such circumstances, in what direction are disclosures on environmental and sustainability issues currently moving?

I'd like you to clarify these two points.

[Ikeo, Chairman] I'd like the Secretariat to answer his questions.

[Inoue, Director of the Corporate Accounting and Disclosure Division, FSA] As for the first question about the term "narrative information", we borrowed the term from the report prepared by the Working Group on Corporate Disclosure of the Financial System Council. Although we used the term "narrative information", what it means is the same as "non-financial information": it refers to narrative statements other than financial information or financial statements.

As for the second question, I understand that you are asking how to present information on the sustainability, or E (environmental) and S (social) factors of ESG. That is exactly what we would like you to discuss, as shown on page 21. It is about materiality, the second issue on that page. Under the current disclosure framework, by judging materiality of possible impact on business results, relevant information should be disclosed. If a company judges the sustainability, for example, an environmental issue, is material, it should be reasonable to describe the issue. How to judge the materiality is one of key points to be discussed here.

[Ikeo, Chairman] I'll hand it over to you.

[Furusawa, Deputy Director-General of the Policy and Markets Bureau, FSA] Thank you. I assume the question was raised in consideration of discussions at the Disclosure Working Group which I was in charge of, as well as discussions on integrated disclosures at the Council on Investments for the Future. Mr. Kobayashi shared his view, looking at a considerably large "framework" of disclosures. Let me briefly explain it. The reason why I used the term "framework" is because the Disclosure Working Group members discussed "narrative information" versus "non-financial information" and pointed out that the term "non-financial" lacks the principle of

what should be disclosed.

The core discussion at the Disclosure Working Group was exactly about the factors that support financial information: specifically, governance before talking about ESG factors which Mr. Kobayashi mentioned, business models for corporate management, so-called MD&A which is the review of corporate management/business results, and risk information in consideration of future risks. The Group concluded that improving descriptions of such factors as business models, MD&A, and risk information should be the starting point of the discussion. In response, we are to discuss the formulation of guidelines or principles this time.

ESG factors as you mentioned would be naturally in the scope of discussion, when considering future corporate value or mid- to long-term corporate value. On the other hand, as Director [Inoue] explained, as for when ESG factors are actually taken into consideration for increasing corporate value, it significantly varies depending on individual companies' business models, or time span to consider corporate management.

In that sense, if ESG factors are considered to be material in terms of risk information or business model, the matter is subject to statutory disclosures. If ESG factors are discussed at the preliminary stage, companies may disclose the matter on a voluntary basis. As for ESG factors or SDGs which is an economic term, the Disclosure Working Group's discussion focused mainly on G (governance), and then discussed when and how companies should incorporate other factors in their disclosures in the future.

That's a brief summary of discussions at the Group for your reference.

[Kobayashi, member] In that sense, I think such terms as "materiality", "financial information versus narrative information", and SDGs are highly discretionary. If we just say "materiality", the scope will be too broad and vague. I suggest that we should narrow down the definition of the term.

Especially when the FSA uses the term "principles", the scope should be narrowed down. Alternatively, looking at all factors including SDGs as mentioned earlier, we should set a specific time period within which companies make disclosures on such factors. Is it really sufficient to describe risks for the time span of a quarter to a year? Or do they need to describe risks over at least 10 years, when we talk about the sustainability. I got an impression that such a point is not clear at the moment.

[Furusawa, Deputy Director-General of the Policy and Markets Bureau, FSA] Thank you for you

input.

[Ikeo, Chairman] We are currently calling for opinions. So, your valuable input will be taken into consideration when formulating “principle-based guidance”.

Mr. Tsukuda, please go ahead.

[Tsukuda, member] Thank you very much. I’d like to share my opinion on three issues listed on Material 2 – specifically fulfilling the board’s responsibilities, cross-shareholdings, and improving information disclosure.

First of all, we conducted a survey on cross-shareholdings among some 2,000 companies listed on the TSE First Section after the revision of the Code, and received responses from roughly 18% of them. The survey results are summarized on page 16 of Material 3. Detailed survey results are available on *Shoji Homu* issued on November 25, 2018.

With regard to cross-shareholdings, as shown on the left graph, 15.5% of the respondents or one out of every 6 companies reported that reduction is difficult due to the business relationship. This result revealed a problem with companies which have made their trading partners hold their shares. As shown on the right graph, roughly 80% of such respondents reported that need for reduction increased due to the revision of the Code. I think this is a very good result.

In other words, those companies used to feel it is difficult to reduce cross-shareholdings because of business relationships, but as the FSA and the TSE revised the Governance Code, they now have a reason for the reduction. That’s what it implies. Therefore, I’d like to express my compliments to those who worked on the revision of the Code in the FSA and the TSE. This is my first point.

Next, I’d like to share my view on fulfilling the board’s responsibilities. As shown on page 14, in roughly two-thirds of all respondent companies, President, who is the chief executive, serves as Chairperson of the board. As shown in the graph on the right, while many companies established an optional Nomination Committee, in one third of the companies, President assumes the role of Committee Chair.

More details of the survey results are available on *Shoji Homu*. Let’s look at cases of Companies with Three Committees (i.e. Audit, Nomination and Remuneration Committees) which adopt the monitoring model. Although the survey universe is rather small, in 25% of such companies, President serves as Committee Chair. Considering this specific form of organizational

structure, I have a doubt about such an attribute of Committee Chair. This is the reality of the companies.

My point is that, while the phrase “from Form to Substance” is often used in the context of the governance reform, as far as the results on page 14 are concerned, I personally think continuous efforts are required to improve both Form and Substance. Before deepening Substance, there still is room for reforming Form. I believe this is a very important point for strengthening the function of the board.

My third point is about improving information disclosure. I look at this issue from a broader perspective, and have a concern about Corporate Governance Reports which companies submit to the TSE.

Actually, this summer, a certain local bank caused a problem with real-estate loans. I was interested in and reviewed the bank’s Corporate Governance Report issued last year, and Corporate Governance Report issued after the scandal. What was written in these two Reports are completely different things.

Last year before the scandal, the bank stated in the Report that its corporate governance was functioning adequately, and it complied with all relevant requirements. However, after the bank’s wrongdoings were revealed, the bank filed a revised report to the TSE, stating that the bank basically failed to ensure good governance.

This Report is used by various stakeholders in the society, including institutional investors, so accurate reporting is required. How could we accept the change in the statement to be 180 degrees opposite to the initial statement? It undermines the reliability of Corporate Governance Report itself.

The Corporate Governance Code was introduced in 2015, and revised this year. Accordingly, I suggest that Corporate Governance Report should also be upgraded in a way to keep up with the changes in the world, and therefore, we should provide guidance on what should be stated in the Report.

Currently, most local banks, except for the bank in question, reported they complied with the Code. Probably, the majority of people do not place much confidence in what is presented in the Reports. Companies [including banks] reported that they complied with the Code according to the ‘Comply or Explain’ approach, so the audience feels that they have nothing to say about that. This

is the reality. So we should take drastic measures to change reporting practices.

That's all. Sorry for the long speech.

[Ikeo, Chairman] Thank you very much.

Certainly, the compliance ratio is very high. Generally speaking, when a company reported that it complied with all principles of the Code, we might wonder if that is true. Rather, if a company provided a serious explanation for non-compliance with a certain principle, we get an impression that the company is earnestly working on corporate governance.

Does anyone else wish to make comments?

[Oguchi, member] I will share my opinions related to the Stewardship Code later.

[Ikeo, Chairman] OK.

Ms. Takayama, please go ahead.

[Takayama, member] I'd like to make some comments in response to Mr. Kobayashi's opinion.

I was also a little confused about the definition of non-financial information, but the explanation helped me understand it. In this Material, the definition of "non-financial information", which should be disclosed, is based on the discussion at the Working Group on Corporate Disclosure. It is information about business models, strategies and the like, which is closely related to financial information or figures. Although it includes long-term factors, it rather focuses on short-term non-financial information. That's my understanding.

Certainly, such information is important. Looking at the example of disclosure in the Annual Report of Rolls-Royce in the UK, such information is included. However, British companies definitely disclose not only such information, but also extensive information on ESG factors. I understand that the Working Group on Corporate Disclosure, because of its nature, focuses on what you explained.

Nevertheless, this Council is concerning the follow-up of both Codes. Both the Stewardship Code and the Corporate Governance Code look to increase corporate value over the mid- to long-term. Furthermore, I believe that the Council is expected to have discussions from a higher-level conceptual perspective.

Long-term investors are very much interested in ESG-related information in other countries. When we discuss such topics as the improvement of disclosures or various principles at this Council, although the framework offered by the Financial System Council is certainly important,

we should also discuss a bigger framework, more long-term views, and the ideal disclosure of overall ESG performance including SDGs.

In this regard, I'd like to report the actual situation of dialogue between companies and investors later in the session about the Stewardship Code. Companies have certainly been working on enhancing information required by the Working Group on Corporate Disclosure. In the meantime, companies are moving toward enhanced disclosures of such mid- to long-term factors as ESG. If we are to discuss the improvement of disclosures at this Council taking into account such situations of Japanese companies, I think we should not focus solely on the scope set by the Working Group, but should discuss matters under a bigger framework.

That's all.

[Ikeo, Chairman] Thank you very much.

Mr. Kawakita, please go ahead.

[Kawakita, member] I'd like to make some comments on governance issues and cost of capital.

My first point is about governance. While other members referred to ESG, I believe that governance is the foundation.

One more thing. When I conducted an ESG analysis with direct assessment data instead of fund data, I found a tendency where companies make efforts to create compelling stories about E or ecology, while placing little weight on governance.

In that sense, I got an impression that, if we cover E and S in our discussion, although such a discussion would be useful in the medium to long run, our discussion at this Council will become unfocused.

With regard to governance, considering the recent Company N's scandal, companies should have Nomination and Remuneration Committees, whether they are statutory or optional, as mentioned in Material 1. President who acts like the owner of the company – although I welcome such a President – tends to do all things in his/her sole discretion. Therefore, it is necessary to have in place a brake on such selfish behaviors.

My next point is about ideal audits. Page 16 of Material 1 states necessity of establishment of an independent audit committee so that the committee can create its own organization for inspection. And it is very important to have a mechanism where such an independent organization serves as a contact point for whistleblowing by employees. So, I support the contents of page 16 of

the Material.

Another point. Listing of Company S in December is a topic of popular discussion. The Company is required to clearly articulate the process of nominating outside directors or inside directors so that investors can make voting decisions at its general shareholders' meeting.

In case a company has optional Nomination and Remuneration Committees, it would be rather difficult to make their conclusion regarded as "the must" at the board of directors. It would be important to clarify whether Nomination and Remuneration Committees appointed candidates, or the board independently appointed candidates.

Then, page 21 states that disclosures should reflect discussions on Capital Cost. any companies currently set their dividend payout ratio at 30% in Japan. I'm wondering why they uniformly set it at 30%. Anyway, the point here is retained earnings, which is profits that have not been distributed as dividends. Companies should disclose to investors how they make use of retained earnings for their future growth strategies – to put it the other way round, they should communicate they need this much retained earnings for their growth strategies.

I'd like to comment on another point for cost of capital. Securities Report includes a statement of financial performance for the past 5 years. Companies should indicate their market cap at the end of the year in the statement, which helps readers easily understand whether the market cap is larger or smaller than shareholders' equity. The capital cost is related to PBR, and such a requirement for disclosure item make the management aware of the situation that PBR is less than 1, then they become more aware of cost of capital. I believe that is a preferable direction.

That's all.

[Ikeo, Chairman] Thank you very much.

Mr. Kawamura, please.

[Kawamura, member] My opinion on corporate governance is the same as what other members already mentioned. I have often realized that the spirit of this Code and its formal requirements are very useful when companies undertake drastic reforms – for example, changing a company from something like a village community to a function-oriented community.

For example, relating to auditing as shown on page 16 of Material 1, I believe that internal audit, auditing firm's audit, and audit by Audit Committee/ *kansayaku* (statutory corporate auditor) are all meaningful, from my practical experience. Under the three-way audit system, these 3 parties

independently conduct audits, with some overlaps; and judge whether each division of a company ensures good governance. Originally, auditing was designed for CEO to check whether each division of the company is functioning in a way to contribute to the sustainable growth, or making a wrong move in a way to impede the growth. However, CEO tends to be too busy to oversee everything by himself or herself, so such checking is delegated to someone else through the three-way audit system in order to ensure the fairness. Those who conducted audits report the results not only to CEO, but also to Audit Committee comprising independent directors or *kansayaku*. Such dual reporting lines prevent Chief Executive Officer's misconduct or insufficient care. The Corporate Governance Code includes many important points about corporate management, and I found it very useful from my practical experience.

Furthermore, I agree with Mr. Kobayashi's opinion that we should consider a wider scope of corporate governance. We are now in an era requiring corporate management in consideration of not only so-called ESG, but also the 17 SDGs adopted by the United Nations. This change occurred in the context of companies' roles in the society and increase in their influence. To communicate such matters to the society, traditional Securities Report alone has become insufficient. An increasing number of companies adopted Integrated Reports, which incorporate Environment Reports, Workstyle Reform Report, etc., as their communication tool. The Integrated Reports contain even statistics on childcare leave by gender, indicating a part of their corporate social responsibilities. In that sense, I also consider that this Council should expand the scope of corporate governance for its discussion in the future.

[Ikeo, Chairman] Thank you very much.

Mr. Tanaka, please.

[Tanaka, member] Thank you very much. This is the first meeting of the new round, so, I'd like to share my views on these key issues.

I'd like to specifically talk about cost of capital and disclosures. On the bottom right of page 20 of Material 1, a typical example of disclosure by Japanese companies is quoted. The Secretariat explained that the progress in corporate governance under the Code has resulted in an increase in ROE. However, I came to wonder whether this framework itself is adequate in the first place. Actually, the example of disclosure by a Japanese company on page 20 exhibits Japan's "Galapagos Syndrome" – so unique and isolated from the rest of the World. In case of disclosures by global

companies, they start with explaining earnings per share (EPS).

Upon quarterly closing or annual closing, companies announce financial results. Japanese companies first explain by what percentage their sales increased or decreased, as shown in the example. On the contrary, global companies first explain how much higher or lower their EPS is compared to the market's consensus estimate. Such a difference in how they disclose their financial results clearly shows the difference in their attitudes in terms of whether they have a strong sense that they disclose information for investors.

Accordingly, I have a doubt about whether it is really appropriate to look at financial results by focusing solely on ROE. I think it is necessary to place more emphasis on earnings per share as a viewpoint.

While the Corporate Governance Code often refers to increasing corporate value, I'm also wondering whether corporate value is measurable. Is corporate value equal to market cap? If corporate value includes such factors as customer satisfaction level, it will not at all be measurable.

Then, if Company A with a market cap of 100 billion yen acquires Company B at 50 billion yen, Company A's market cap will increase, and thus its corporate value will automatically increase. For a company which continues to engage in mergers one after another repeatedly, mergers drive the growth of its corporate value. Is that what is expected here?

Repeated mergers drive the growth of gross margin as well as operating income. However, there still is a possibility that earnings per share is decreasing. I suggest that we should reconsider the definition of corporate value here. We should figure out differences between corporate value and shareholder value, and consider where the Governance Code is heading, from a fundamental perspective. Today's discussion made me feel like that. This is my first point.

In particular, in connection with my first point, Material 1 shows a graph under the title of "managing business in consideration of cost of capital" on page 5. Looking at dots on the graph, aside from big arrows, we can see there are a large number of companies whose PBR is less than 1. I noticed that almost all banks under the oversight of the FSA have a PBR of less than 1. Is that really appropriate to consider only ROE under such circumstances? This is my first point.

My second point is related to what Professor Kawasaki mentioned on fulfilling board's responsibilities. It's about exactly who appoints outside directors. As I mentioned some other time, in the US and Europe – especially, in the US, most board members are outside directors. The

typical board composition is outside directors plus CEO. Over there, outside directors appoint candidates for outside directors. In most cases in Japan, President or Chairman pays a visit to ask someone to be outside director. Companies in a business relationship mutually appoint candidates for outside directors: these days, as in cross-shareholdings, such directors are called “cross-appointed directors” or “cross-appointed officers”. Accordingly, when we discuss the fulfillment of board’s responsibilities, who appoints director candidates should be a very important point.

Another issue on cross-held shares. We’ve been discussing why cross-shareholdings should be reduced. The biggest problem would be the increase of silent shareholders or shareholders who approve everything proposed by the company. What about the Bank of Japan (BOJ)? We do not have to think about the BOJ?

Is the BOJ an institutional investor? Is the BOJ an asset owner or asset manager? The number of shares held by the BOJ has been rapidly increasing. In many large companies in Japan, the largest shareholder is the BOJ.

While we highlight the issue of cross-shareholdings, considering the overall shareholding structure, I believe we, the Council, should present our opinion on shareholdings by the Bank of Japan.

I conclude with comments on auditing. Some members expressed their views as practitioners. I agree with what they mentioned. We have observed corporate scandals of large companies, including Company N, one after another. Upon such scandals, people ask what directors were doing, but they do not publicly ask what *kansayaku* were doing.

In that sense, although we decided to promote ‘growth-oriented governance’ for various reasons when we started our discussion on the Corporate Governance Code, I think it is time to include ‘defensive governance’ in our discussion as the second core issue.

That’s all.

[Ikeo, Chairman] Thank you very much.

Mr. Sampei, please go ahead.

[Sampei, member] Thank you very much. I’d like to share my impression about five topics [from Sections 1 to 5 of Chapter II] as shown on the Content of Material 1.

Relating to Section 1 about cost of capital, the TSE will hold a seminar on cost of capital in

December. While the number of available seats is 300, the seminar was oversubscribed very quickly. I was impressed that so many business people are willing to learn afresh cost of capital. I talked about it with some foreigners. It is a positive thing in a certain sense: the topic draws so much attention, and people want to refresh their knowledge. On the other hand, I'm also surprised by the fact so many people are not familiar with cost of capital by now.

What is important here is that they should not be satisfied with merely calculating their cost of capital and stating, "Our company's cost of capital is considered to be XX%". As Ms. Waring mentioned in her opinion statement, capital allocation is very important. They should ask themselves whether their capital allocation practices are accountable? Companies will never be able to ensure reasonable capital allocation without understanding their cost of capital. Therefore, to this end, they need to understand their cost of capital and recognize what action they need to take? Our discussion on "business management in consideration of cost of capital" should cover such matters.

Section 2 is related to the scandal of Company N, which has been drawing public attention since last week. Looking at the case, I felt it's a good thing that the Governance Code was already revised on many points. People realized anew the importance of the appointment/dismissal of CEO, use of committees, and disclosures of directors' remuneration. In that sense, it was good to have revised the Code in advance, not in response to the scandal. It became a good opportunity to inform the broader public of the intention for the revision.

As data was provided earlier today, the number of outside directors has been rapidly increasing among listed companies, yet most companies do not have one-third outside directors, not achieving the level mentioned by Ms. Waring.

In that sense, as the size of committees is smaller, it is relatively easier for companies to achieve a higher percentage of outside members: for example, even if a company has only 2 outside directors on the board, its committee could comprise these 2 outside directors as well as outside *kansayaku*, if any. Companies could use such tactics.

In this connection, I know I'm referring to Company N again, but the company announced that it will establish several committees, because it suddenly faced so many issues and found it difficult to make decisions without establishing such committees. I'm wondering why the company does not make use of outside *kansayaku* there. In this sense, I think it is also necessary to clarify how

companies should use committees.

The next topic is cross-shareholdings. While I talked with many individual companies about cross-shareholdings, they reported that they started working on the reduction, or they took such an action, or they made disclosures. In that sense, I got an impression that the revision of the Code encouraged them to take actions, while the internal environment had not allowed them to propose the reduction before.

I think we should look at their efforts on an individual basis, while it may be also necessary to have statistics like the percentage among all companies. If you look at disclosures of individual companies, you will find significant differences among companies: some companies report only a few companies on the list [of cross-shareholding partners], and some companies report 200 to 300 companies on the list. The total value of shares of those 200 to 300 companies amounts to several hundred billion of yens, that is much larger than the portfolio value of a publicly offered investment trust. There still are many such cases.

On the other hand, looking at changes, there are some companies which have reduced cross-shareholdings by more than 90% in terms of value over the past 3 years. Therefore, it would be necessary to distinguish companies proactively working on the reduction from companies not yet making reduction efforts on a company by company basis.

I referred to *kansayaku* earlier, and Mr. Tanaka also talked about it. While I talk with *kansayaku* about the introduction of Key Audit Matters (KAM), they assume that, upon disclosure of KAM, *kansayaku* need to answer inquiries or have dialogue with investors about KAM, and therefore, they feel they need to get ready for that. But is it really so? I assume it should be the management team, namely CFO or CEO, who is responsible for answering such inquiries. What expectation do they have, while preparing for the introduction of KAM? We may need to sort out such matters as well.

Finally, I'd like to refer to the improvement of disclosures. One of the members asked a question about narrative information, and Deputy Director-General Furusawa answered the question earlier. The important thing here is that it is called "narrative information" because it describes various factors including the background of financial information as well as ESG or non-financial information, and explains how each factor is linked with other factors. Relating to matters or factors which cannot be expressed by tables or figures, companies describe relations

between factors, by stating “This and that are linked in this way.” I understand that we are expected to facilitate further improvement of such disclosures.

Some members talked about ESG and SDGs earlier, and it is OK to encourage proactive communications about ESG or SDGs. My biggest concern, however, is that such factors will be categorized as a separate disclosure item. If it happens, it will be very much misleading.

What we expect companies to describe is how they consider ESG as a part of their activities, especially business activities; or when companies regard something which falls under any of the 17 SDGs as an opportunity and decide to work on it, how it will be reflected on corporate value over the long term. If you require companies to disclose their ESG or SDGs-related activities as an independent disclosure item, it will be a big failure, I think.

we, therefore, need to be careful about how we incorporate these matters into disclosures to avoid such a failure when we discuss the improvement of disclosures.

That’s all I have to say.

[Ikeo, Chairman] Thank you very much.

Mr. Matsuyama, please go ahead.

[Matsuyama, member] Thank you. As discussed earlier today, we have seen a progress in initiatives by both issuing companies and investors through the implementation of both Codes.

In particular, in response to the revision of the Corporate Governance Code in this year, each company is now working on governance by maintaining existing [good] governance practices or changing its approach if the existing one is insufficient. Companies are facing critical moments in working on implementing the revised Code in a manner appropriate to its business environment, and making voluntary efforts to enhance the effectiveness of its governance.

Under such circumstances, today’s agenda about corporate governance includes the improvement of disclosure. Various issues are listed up on page 21 of Material 1. Various views have been already expressed. I understand that the FSA is working on formulating “principle-based guidance” in response to the Report issued by the Working Group on Corporate Disclosure. Toward the improvement of disclosure which will be more useful for dialogue between companies and investors, it is considered to be a good thing to present these 5 points as well as specific examples of disclosures from various viewpoints.

Meanwhile, we need to be careful to avoid the following situation: just because there is

guidance, companies overly focus on what is written in the guidance, and thus make merely formal and stereotypical disclosures.

I used to prepare Securities Report for many years, although it was a long time ago. For me, Securities Report has an image of a highly formal statutory document. So, I now regret that I used to focus on the accuracy of content, and pay sufficient attention to whether the report fully satisfies legal requirements, rather than ensuring reader-friendliness as written at the bottom of page 21.

One of the causes is extremely difficult expressions used for Securities Report. Notes for financial information in the latter half require very difficult expressions, and corresponding to them, non-financial information in the first half is also provided in the overly formal style, I assume.

Meanwhile, in case of Annual Report, although financial information is provided in the same style [as that of Securities Report], the first half is written more freely. I think many companies write about their CSR activities or ESG initiatives relatively freely, although not as much as in Integrated Report.

As for Business Report, which is a statutory document to be used for general shareholders' meetings, companies provide explanations intended for general shareholders in the first half of the report by using charts and photographs. Companies seem to have a stereotypical view because Securities Report has the format required by law, it should be written in a formal style. I think they cannot yet dispel such a stereotypical view from my own past experience.

Taking this opportunity, I suggest that the Council should offer a direction to companies by introducing best practices or examples of disclosures, and make them understand that they could write more freely in an easy-to-understand manner.

[Ikeo, Chairman] Thank you very much.

Please go ahead.

[Oba, member] Thank you. Many members already expressed various views on the Governance Code, so, I don't have much to add. I just want to talk about one thing, which other members have not referred to.

Based on various survey results, many concerned parties recognize that the establishment and promotion of these 2 Codes have significantly contributed to governance of companies. This is the premise. I understand this meeting is held to make governance efforts more effective. I'd like to make two points on the Corporate Governance Code.

First, in the Governance Code, while General Principle 4 refers to roles or evaluation of the board, Principle 4.11 clearly stipulates preconditions of board effectiveness. It is written that unless companies fulfill such conditions, they will not be able to increase board effectiveness.

Therefore, it should be the precondition that each company discloses how it recognizes this Principle and evaluates the board. Specifically, it is mentioned that each year the board should analyze and evaluate its effectiveness as a whole, taking into consideration the relevant matters, including self-evaluations of each director, and that a summary of the results should be disclosed. I believe that most companies comply with this Principle, but I feel we should once again check whether their disclosures conform to the intent of this Principle. This is my first point.

Another point is about cross-shareholdings. We agreed on discussing that cross-shareholdings should be reduced because of 2 issues. One is a hollowing-out of governance, another is a possible distortion of price formation: there is a possibility of price formation regardless of fundamentals.

This is a very difficult issue, and regarded as the last bedrock. More confusingly, as Mr. Tanaka pointed out earlier, in the market, there is a move to the direction opposite to the reduction. Overall, there may be a progress in disclosures of cross-shareholdings. However, there is a possibility that the BOJ's shareholdings through purchases of ETF are highly static. Another concern is about cross-shareholdings between publicly listed parent/subsidiary pairs, which are also highly static. Accordingly, while trying to normalize overall price formation, prices could be distorted. We should consider this issue further.

That's all.

[Ikeo, Chairman] Thank you very much.

Now I would like you to discuss issues about initiatives under the Stewardship Code.

I would appreciate it, if you made comments on additional disclosure items in the "List of institutional investors signing up to Japan's Stewardship Code".

Please go ahead.

[Oguchi, member] Thank you. When I was named as a speaker by Chairman Ikeo earlier, I hesitated to make comments. I'll tell you the reason. As shown on page 3 of Material 1, the Corporate Governance Code and the Stewardship Code work together as "the two wheels of a cart" for increasing corporate value over the mid- to long-term. Considering such a structure, I wanted to share my views, not as issues on the revision of the Corporate Governance Code, but from the

standpoint that it is important to ensure both Codes work together.

In such a context, before talking about the Stewardship Code, I'd like to make some comments on the Corporate Governance Code. As other members mentioned, it is true that the significant progress of the governance reform has been driven by companies which have been autonomously working on their own governance reform under the 'Comply or Explain' approach that allows them to flexibly respond to the Code, where it has no binding force except for disclosure requirements.

On the other hand, exactly because of its flexibility, merely formal compliance or superficial explanation could be permitted as a result, as in the earlier-mentioned example of the change in the statement to be 180 degrees opposite to the initial statement in a year. Then what is happening now is an increasing disparity between companies which are autonomously taking initiatives and other companies.

Among various issues, some members discussed cross-shareholdings. Some principles are rather difficult to make a sufficient progress on, while companies made a major progress with some other principles: there seems to be a disparity among principles as well.

Then how can we overcome such a disparity? One possible approach is an orthodox method: we can promote autonomous corporate initiatives by sharing the intent and philosophy of the Code through this Council. That is a great thing, but there may be a limitation of such an approach. So, I'd like to move on to discussion on the Stewardship Code.

Although there is no legal restriction, when institutional investors address the Stewardship Code, it is institutional investors who have dialogue with companies – more than 2,000 companies listed on the TSE First Section alone. Some institutional investors express their intentions by selling shares halfway through, but most institutional investors express their intentions by exercising voting rights. Then it is very important to maintain the effectiveness of voting as a method for indicating their intentions to investee companies.

While talking with corporate executives, I sometimes hear their complaints. For instance, they say, "We had dialogue on various matters with investors, but such dialogue was not reflected on their voting decisions. Then what are the advantages of dialogue?" I'm concerned that there may be many cases where engagement/dialogue is isolated from voting.

On the other hand, institutional investors need to make voting decisions based on objective criteria. I can understand it. However, since companies spared precious time for dialogue with them,

the investors should provide more explanations about how they exercised their voting rights based on the engagement. Alternatively, although it is when companies cannot choose shareholders, companies should ask such questions to the investors. I dare say that voting is an effective weapon, if not a compelling power. So, it would be necessary to enhance the effectiveness of the “Comply or Explain” approach.

In that sense, although no explanation was provided today, I’d like to refer to the table on page 33 of Material 3. It’s about a legal requirement in the US Act of 2017 (under Senate deliberation) – the third one. Now they are deliberating the requirement for proxy advisors to provide companies with a prior opportunity to review and comment on their proxy advice. Although this is intended for proxy advisors, I think the same logic will apply to asset managers.

This requirement is somewhat related to Japan. In Supplementary Principle 1.1.1 of the Corporate Governance Code, it is stipulated, “When the board recognizes that a considerable number of votes have been cast against a proposal by the company and the proposal was approved, it should analyze the reasons behind opposing votes and why many shareholders were opposed to the proposal, and should consider the need for shareholder dialogue and other measures.” When companies put this principle into practice, institutional investors need to inform companies of reasons why they cast opposing votes. Although Material 1 refers to disclosures of reasons for casting opposing votes, regardless of whether or not it should take the form of public disclosure, investors should at least inform relevant investee companies of reasons for their voting decisions. I believe that individual dialogue on voting results will complement the weakness of the “Comply or Explain” approach and therefore will be very meaningful.

With regard to dialogue, Dr. Ueda expressed her concern about the quality of dialogue in her opinion statement, and Mr. Iwama referred to collective engagement in his opinion statement. Unlike the UK’s Stewardship Code, Japan’s Stewardship Code does not refer to escalation. We may need to discuss how to reinforce dialogue.

For example, although Ms. Waring is not here today, as stipulated in the ICGN Global Stewardship Principles, collective engagement is generally used as a tool of escalation for investors, who do not hold a large number of shares on an individual basis as oppose to activists, to get together to exercise influence.

Collective engagement is not included in today’s agenda. Although collective engagement itself

is meaningful, unless we discuss escalation first and then discuss collective engagement as a tool for that purpose, collective engagement will end up to be merely for form's sake, and lack substance.

Again, as stipulated in the ICGN Global Stewardship Principles, each country, including Japan, certainly has laws and regulations on "acting in concert" or joint shareholding. How do we address this issue? It should be an essential part of discussion on collective engagement.

I also wish to talk about ESG. My view may be close to those of Mr. Sampei and Mr. Kawakita. I believe that discussion on ESG is related to cost of capital, which is one of today's topics.

Perhaps surprisingly, active managers use cost of capital to discount future cash flow to present value and there has been a problem with the term of the future cash flow being too short. I think this is the background of an increasing emphasis on ESG. For instance, when setting the term at 10 years instead of 2-3 years, the issue of stranded assets is likely to be raised. This asset is currently used, but cash flow will be deteriorated if it becomes unusable in the future; or cost of capital will increase due to regulations in the future. Naturally, such discussions emerge. Even if they do not explicitly say so, I assume active managers have evaluated companies over the long term taking ESG factors into consideration from such a perspective.

Considering ESG from such a perspective, similarly to Mr. Sampei's opposition to separating ESG from other disclosure items, or Mr. Kawakita's opinion that G is the foundation, I usually refer to ESG as "ES through G", and believe that unless we clarify ES in investments, our discussion will become unfocused, and we will not be able to discuss essential matters.

Moreover, I'd like to point out that this issue is already mentioned in Guidance 3-3 of the Stewardship Code. The Guidance stipulates that it is important to consider risks and opportunities including those arising from social and environmental matters. Related to what I mentioned earlier, risk is an issue of cost of capital, and opportunity is an issue of future cash flow. I think these are the criteria by which to judge the materiality. Unless you consider social value is more important than economic value, if you look at ESG from the perspective of increasing corporate value, I think this should be the right interpretation.

Finally, changing the subject, I'd like to talk about defensive governance. When I looked at page 16 of Material 1, I found that is exactly what I think. I've been arguing the matter for a long time.

Let me repeat what I mentioned at the 13th meeting in December 2017, referring to another corporate scandal back then, not the recent scandal of Company N. "... overseas investors cast wary eyes on recent corporate scandals. When a corporate scandal occurs, it is common that the company in question subsequently establishes a third-party committee, consisting of only independent members, that carries out a neutral, fair and objective investigation from an independent standpoint. Such a third-party committee investigates the matter from various angles. Actually, I talked about this 2 years ago at this Follow-up Council", which means I've been arguing the same thing for the past 3 years. "Considering that there is no end to corporate scandals, a third-party committee should be established beforehand and retained as a permanent body, instead of establishing it after the fact. Once again, I'd like to suggest that we should review [each role of] *kansayaku* board (board of corporate auditors), audit committee and supervisory committee. I often hear a concern about the quality of auditing from those who are not familiar with business operations when discussing audits by independent directors. According to the Third-Party Committee Guidelines [for Company Scandals] issued by Japan Federation of Bar Associations, this concern can be addressed by requiring companies to establish a secretariat which consists of an appropriate number of employees and directly reports to the third-party committee. On the assumption that a third-party committee plays a certain role ex-post facto, the internal audit department could assume the role of the secretariat, and highly independent *kansayaku* board (board of corporate auditors), audit committee or supervisory committee could play the role of such a third-party committee, to which the secretariat reports" as indicated on page 16. "In that case, since the said committees have legal authorities which a third-party committee does not have, we can expect that 'defensive' governance will be strengthened."

I repeated what I mentioned a year ago as it is. I hope we will have in-depth discussion on the matter written on page 16.

That's all.

[Ikeo, Chairman] Thank you very much.

Ms. Takayama, please.

[Takayama, member] I'd like to talk about the current situation of dialogue between companies and investors, who is related to both the Governance Code and the Stewardship Code.

Although some may be concerned about the quality of dialogue, I believe that what is discussed

during dialogue has certainly improved after the implementation of both Codes as other member already mentioned. In that light, I'd like to share some positive examples I've seen. As a part of my job, I've been involved or participated in dialogue between companies and investors. From such experience, I'd like to inform you of the trend of dialogue.

The pie chart on page 23 shows that the number of investors who have made individual disclosure of voting records accounts for less than 50% of all investors. However, almost all key institutional investors have made such disclosures. We can say more than 90% of investors have made company-level disclosures in terms of the value of assets under management.

This fact has a significant impact on companies. It means that almost all key shareholders of companies have made company-level disclosures.

As a result, companies have more interest in voting results, and have more opportunities for dialogue with investors about their proposals. The companies have such dialogue not for asking the investors to support their proposals, but for sufficiently discussing in advance any factors to which the investors may be opposed, and modifying their proposals as necessary to gain support from the investors. Such dialogue has been increasing.

Let me introduce some investors' rules on voting disclosures. In case the investors voted against any proposal of an actively managed company, their fund manager must inform the company of the fact that they opposed the proposal and reasons for the opposition at IR meeting or the like. There are several investors who have such a rule. Upon voting against proposals of their investee companies, the investors are increasingly providing more detailed explanations on reasons for such decisions.

Furthermore, both companies and investors are increasingly discussing long-term issues, including initiatives under the Governance Code, reform of the board, and other ESG issues.

Various opinions on ESG have been shared today, and basically my view is similar to them. I use the term "G first", meaning Governance First, and E and S are considered in that context. Global investors often use this expression. I agree that governance is the most important.

However, there is a new move among companies. Some companies communicate with investors about their views and initiatives on ES ensuring governance as the foundation, as well as how such initiatives are linked with corporate value. The number of companies, which hold ESG-related meetings for Japanese or foreign investors, is gradually increasing, although the number of such

companies is still small.

As the basic information for such meetings, companies set targets – for example, in their medium-term business plan – including ESG factors. Then they declare such targets, and have discussion with investors based on them.

Meanwhile, more investors are welcoming about opportunities where companies explain their initiatives on governance, and other mid- to long-term key issues. Many investors would like to deepen their understanding through a series of dialogues.

Let me share specific comments from investors with you. For example, investors sometimes found that companies' first explanations on ESG are not sufficient, but it does not matter. They could continue dialogue after that. Continuous dialogue is significant. I got an impression that an increasing number of investors feel that way.

I heard the following comments from companies until last year: although investors say they regard G or ES as important, their attitude toward such factors seems merely formal. However, it has been changing. For example, prior to a meeting with a company, an investor prepares a report on the company related to ESG factors which the investors consider important in making investment decisions, and then has dialogue based on the report. There also is a case where an investor brings data of an ESG rating agency, and provides specific advice on making easy-to-understand disclosures for investors.

[Ikeo, Chairman] Excuse me, but we do not have time for more examples...

[Takayama, member] I see.

[Ikeo, Chairman] Could you please share examples and related comments later in the form of reference material?

[Takayama, member] Sure. As I mentioned, both investors and companies have been changing. Taking such a situation into account, I support the proposed enhancement of disclosure items in the list of institutional investors who signed up for the Stewardship Code.

[Ikeo, Chairman] Thank you.

Mr. Takei, please go ahead.

[Takei, member] I'd like to make two points. My first point is related to corporate governance, as all other members made comments on governance earlier. It is true that there still are various issues on governance even after the revision of the Governance Code. However, we can also see a

steady improvement through the implementation of the Governance Code and initiatives under the double Codes. Therefore, we should externally communicate such facts.

For instance, the Secretariat earlier explained various data including ROE and PBR. There are other positive data: The current profit to sales ratio of Japanese companies hit a record high according to the recent statistics. There are Japanese companies' initiatives – for example, for transforming their business models or increasing their pricing power – in line with the objective of growth-oriented governance in the background of these events. Such changes may not have been driven solely by the governance reform, but prove the fact that the governance reform has made a steady achievement. We should announce such achievements as well.

When we look at all 2,100 companies listed on TSE First Section as the universe, the overall achievements tend to be understated. For example, the number of companies with Nomination Committee accounts for some 30% of companies listed on TSE First Section, while the percentage exceeds 60% among JPX400 companies. By using various universes other than TSE First Section, we can see various positive outcomes. In consideration of such universes in statistics, we should introduce good examples of corporate initiatives as best practices as well as outcomes of the governance reform. This is my first point.

The second point is related to the Stewardship Code, or my concern about ensuring the effectiveness of the Stewardship Code. Guidance 5-2 of the Stewardship Code stipulates that “Institutional investors should have a clear policy on voting and should not be comprised only of a mechanic checklist: [the policies] should be designed to contribute to sustainable growth of investee companies.” Furthermore, Guidance 5-4 stipulates, “When institutional investors use the service of proxy advisors, they should not mechanically depend on the advisors' recommendations, but should exercise their voting rights at their own responsibility and judgment, based on the results of the monitoring of the investee companies and dialogue with them.”

This may be related to Mr. Oguchi's comments. There still is a problem within an institutional investor – a separation or lack of communication between persons who have dialogue with investee companies and voting decision-makers. In addition, while many proposals by the companies are those for election of directors and corporate auditors, I'm wondering whether institutional investors comply with Guidance 5-2 and 5-4 when using their independence criteria. Specifically, I'm concerned that institutional investors' judgement on independence may be made in an overly formal

manner.

Especially when listed companies need to increase the number of independent directors in many ways in the future, for the purpose of appointing adequate persons as independent directors, institutional investors' current approaches to independence and relevant practices need to be reviewed.

For example, when an asset manager has its formal independence criteria, even if a company explains that an individual candidate is qualified to be an outside director because the candidate is helpful for this and that, or from the perspective of ensuring the diversity, the asset manager peremptorily refuses any explanation. Despite the explanation, the asset manager does not change their judgment. There is such a tendency clearly. Since institutional investors must make a massive number of voting decisions in a short period, I understand that sometimes they have no choice but to make formalistic judgments to some degree. However, some institutional investors are sticking to formal procedures: for example, once they made a judgement to turn down a candidate according to their formal criteria, they vote against the candidate even if he/she may be actually qualified; or they mechanically follow their proxy advisor's judgment.

Of course, I don't mean that investors must change their judgments just because companies provided explanations face to face. On the other hand, I believe that listening to face-to-face explanations is necessary for constructive dialogue. In the background, there is a macro factor that institutional investors have been increasingly adopting the passive investment strategy. As other factors, asset managers may be feeling troublesome to explain to asset owners; or asset managers do not have the flexibility to receive face-to-face explanations. I'm not sure what the actual causal factors are. Nevertheless, we should be aware of the issue of securing the effectiveness of Guidance 5.2 and 5.4, as mentioned earlier, especially for the purpose of electing truly competent/necessary people as independent directors.

As for the concept of independence, we need to be aware that independence criteria are a negative list. For example, when there are 100 items to check, a candidate should not be applicable to any of such 100 items, regardless of the fact that the actual number of items the candidate is applicable to, in terms of conflicts of interest, is just 5 or 10. When a company needs to have the board comprising one-third of independent directors or increase the number of independent directors in the future, I doubt whether truly meaningful persons will be appointed as outside

directors if the current practices of institutional investors for the independence remain unchanged. Similarly, as stated on page 16, functions to be performed by independent directors are expanding in the future, while the internal audit department is expected to report directly to independent directors, or Nomination Committee needs independent members. Under such circumstances, when companies need to appoint truly helpful outside directors, is that OK not to change the current practices of institutional investors for their independence criteria? I have such a concern in connection with Guidance 5.2 and 5.4. These points may not be related to disclosures on the website as stated on page 25, but I wanted to raise this issue. This is my second point.

That's all.

[Ikeo, Chairman] Thank you very much.

Mr. Tsukuda, please go ahead.

[Tsukuda, member] I'll briefly make comments based on the survey results which I shared with you earlier. When we asked what they discuss during a dialogue between institutional investors and companies, their answers were the same old story, as Mr. Toyama, who is absent today, often says. According to the survey results, they mainly talk about financial results and future outlook of the companies, or shareholder return policy. In the meantime, I found an encouraging result as well: especially among Companies with Three Committees (i.e. Audit, Nomination and Remuneration Committees), wide-ranging topics are discussed during the dialogue.

The survey found that they discuss various topics, including mid- to long-term business strategies, corporate governance structures, cross-shareholdings, CEO's competency/qualifications, remuneration for directors and officers, and CEO succession planning.

Secondly, when we asked to what extent dialogue with institutional investors contributes to increasing corporate value, again encouragingly, 49.3% of respondents answered that they consider dialogue significantly contributes to the increase. It is a very favorable result that more than a half of the companies consider that dialogue or engagement significantly contributes to increasing corporate value.

In response to the survey results, I thought about future challenges. Upon the previous revision of the Stewardship Code, I believe that disclosures of voting records contributed to the improvement of corporate governance of Japanese companies. The next issue to be worked on would be related to Principle 3 of the Stewardship Code (on page 12) stating that institutional

investors should monitor investee companies. This is the core of the Code, and still needs to be worked on.

The reason for that is based on the survey results. When we asked the companies about their future challenges on dialogue with institutional investors, we found that they seriously thought about challenges. 44% of the companies pointed out their dialogue skills, and 33.8% referred to their own awareness. Yet the most common answer was institutional investors' understanding on the company's businesses, which accounted for 61.8%.

Considering that most respondent companies are more proactively working on the governance reform than other listed companies, I think it is institutional investors who have the key to success in the future dialogue, rather than companies. In particular, it is necessary to work on improving the ability of institutional investors to understand the companies' businesses over the mid- to long-term.

I feel odd that institutional investors do not have an ability to understand businesses of investee companies. Anyway, we need to work on the improvement.

That's all.

[Ikeo, Chairman] Thank you very much.

Mr. Kobayashi, please.

[Kobayashi, member] I have two questions.

Page 27 of Material 1 shows only domestic pension funds. From the standpoint of corporate manager who is judged by the market, I'm eager to know the amount of funds managed by long-term oriented foreign investors, and the size or number of activists. In some companies, the number of activists accounts for roughly 70% of all shareholders. I'd like to know the positioning of foreign investors and activities in the market.

Another question. While engagement activities include dialogue with CEO or executive officers, there are many institutional investors who wish to have dialogue with outside directors. How should we think about guidelines for that?

[Inoue, Director of the Corporate Accounting and Disclosure Division, FSA] Many foreign institutional investors have signed up to Japan's Stewardship Code, so I believe they can effectively have dialogue with companies.

Formulating guidelines for dialogue with outside directors may be an issue to be addressed. We

heard from institutional investors that an increasing number of Japanese companies have provided investors with opportunities to talk with their outside directors. So we will consider your suggestion as an issue to be addressed in the future.

[Ikeo, Chairman] Mr. Sampei, as time is running out, could you make your comments brief?

[Sampei, member] I'd like to make just one point. Various discussions have been made on engagement. In the preambles of both the Stewardship Code and the Corporate Governance Code, the term "dialogue" or "engagement" is accompanied by a premodifier "constructive" as in constructive engagement or purposeful dialogue. While the term "constructive" is very important here, when we just say "engagement", as Mr. Tsukuda mentioned earlier, many people regard conversations at ordinary IR meetings as engagement. Therefore, I believe it is necessary to once again ensure that we are referring to "constructive engagement" by adding the modifier.

I hear that some people understand the term "constructive" is almost equal to "friendly", which is the antonym of "hostile". Therefore, many people have an image of peaceful interaction. However, the term "constructive" means "to achieve results" or "to produce good results". Having engagement itself is not the objective. Instead, as a result of engagement, a problem will be solved, or an achievement will be made. We need to clarify that we can call it "engagement" only when both parties understand such objectives and have purposeful dialogue.

We define the term "engagement" that way, and internally monitor results of engagement. I believe we should ensure that parties concerned understand the definition of engagement as the starting point.

That's all.

[Ikeo, Chairman] Time is running out. If you really have to, please express your view.

[Matsuyama, member] If the additional disclosure items on page 25 are posted on the [FSA's] website, we will see further progress in voting disclosures. Business corporations cannot figure out why investors voted against their proposals. On the other hand, I heard that compiling voting records imposes a heavy burden on institutional investors. I suggest that sufficient discussions with institutional investors are required for moving in that direction.

That's all I have to say.

[Ikeo, Chairman] Thank you very much.

I know you still have a lot to say, but it's already the scheduled closing time. So I'd like to close

today's discussion. The discussion is not over yet and will be continued in the coming months.

As for "principle-based guidance", the FSA will take into account today's discussion, continue to hear opinions from investors and companies, and deepen the discussion.

Lastly, the Secretariat will make some announcements.

[Inoue, Director of the Corporate Accounting and Disclosure Division, FSA] Thank you very much.

As Chairman just mentioned, the Secretariat will prepare the draft "principle-based guidance" for the public comment procedure in early next year, based on today's discussion. If you have any additional opinions, please let us know.

The FSA will conduct a necessary review for the enhancement of disclosure items in the "list of institutional investors signing up to Japan's Stewardship Code", based on today's discussion, and work toward the publication of the draft guidance.

Then, we will fix the date of the next meeting of the Follow-up Council, which is convenient for you and let you know later.

That's all from the Secretariat.

[Ikeo, Chairman] Thank you very much.

Thank you very much for your active participation and inputs. Now I declare the meeting adjourned. Thank you.

END