Provisional Translation

Opinion Statement for the 20th Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code

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For the revision of the Corporate Governance Code, I'd like to first point out two extremely important ongoing changes in environmental factors.

"Acceleration of DX leading to the spread of IX and increased significance of CX"

Due to COIVID-19 pandemic, digital transformation (DX), which was already underway, has been even more accelerated. As a result, industrial transformation (IX), where industrial structures and business models significantly change, is occurring in wide areas. This urges many of existing listed companies to transform their operating models, quickly restructure their business portfolios, and promptly change/reconstruct organizational functions and capabilities. In other words, we are entering an era that puts companies to the harsh test for their abilities to achieve corporate transformation (CX) that fundamentally and uninterruptedly transforms their forms centering on decision-making abilities/systems.

"Increased significance of resilience in response to frequent black swan events"

We have frequently seen devastating black swan events on a global scale: the asset-price bubble burst and financial crisis in Japan (1990s), the Asian financial crisis (1997), the dot-com bubble burst (1999), Lehman shock (2009), the European debt crisis (2010), and the current pandemic. During such a crisis event, a supply chain shock and demand-side shock on a global scale occur in tandem with financial systemic risk, and the entire economic system is exposed to the crisis. On an individual company level, what is often called for in such a crisis is the survival ability and resilience based on the management's ability for making prompt and decisive decisions and implementing them.

In such a rapidly changing environment, the governance reform needs to be further promoted. Companies need to cleverly survive a disruptive crisis, and even launch restructuring. To make DX~IX a growth opportunity, they should aggressively take risks to make investments and execute M&A deals, while at the same time promptly eliminating businesses/functions that no longer have potential for growth and competitiveness. To make such decisions, a

governance system and strong leadership of top management, who is appointed/dismissed under the system, are increasingly becoming critical. Solid operating profitability and a strong financial foundation (especially, capability of generating operating cash flow) enabled by such aggressive management will lead directly to resilience against black swan events.

Therefore, in today's meeting of the Follow-up Council, it is extremely important to discuss the following points as issues for the revision of the Code:

1. Enhancing nomination committee and process for selecting top management

It is absolutely important to further enhance the system (including an optional nomination advisory committee) and process for selecting the next top management. I believe that the establishment of nomination (advisory) committee should be obligatory as a general rule, and the revised Code should clarify that its most important mission is the appointment and dismissal (including non-reappointment) of the next top management. Furthermore, the revised Code should clearly state that independent directors should comprise a majority of a nomination (advisory) committee, and the committee is mainly composed of management talent who have diverse management experience, especially those who have insights into management which cannot be obtained within the company in question. The selection process should not be just an approval of a final personnel proposal prepared by the executive body, that is presented without notice. Instead, the Code should recommend a generalized process that takes at least 3 years to monitor and evaluate internal and (if necessary) external candidates and narrow down the list. So-called "succession plan" will not function effectively and sustainably without substantive and proactive involvement of the nomination (advisory) committee.

2. Ensuring diversity at the level of executive officers (*shikkoyakuin*)

In order to undergo CX that responds to major changes of the era or DX~IX, it is indispensable to ensure diversity (in terms of gender, age, nationality, education, managerial background, etc.) of candidates for future top management and CXO. In the era of DX~IX, diversity of core human resources precisely defines a company's competitiveness and transformation capability. The effectiveness of a succession plan also depends on the quality and diversity of human resources portfolio on the level of executive officers who are candidates for future top management. The Code should state this point including numerical targets. These days, diversity on the board level – merely on the outside director level – is already outdated.

The essence of the CX capability is the capability of transforming organizational ability of the entire company from the management level to the field level. Traditionally, Japanese companies hire new graduates all at once for lifetime employment and adopt the seniority system. Accordingly, companies are characterized as extremely homogeneous, static, and closed; and most of executives are middle-aged or older Japanese males. It is clear that such companies cannot survive in the age to come. Since the Code aims at sustainably increasing corporate value, it is reasonable that the Code should explore this issue.

3. **Importance of capital cost and operating cash flow (≒EBITDA) as well as elimination of traditional nonsense**

In such an era, generating a return that exceeds the cost of capital in normal times is a basic requirement concerning shareholders' value, but also sustainability of a company. "Lead and Disrupt" (C. O'Reilly and M. Tushman) was awarded a special prize in the business leader category of Business Book Award this year. As pointed out in the book, in the era of disruptive innovation, companies must always make high-risk large investments in exploring new areas. Companies, which cannot clear a hurdle of capital cost, have no choice but to depend mostly on debts to fund high-risk investments, and eventually lose sustainability. Exploitation Investments/management by narrowing existing businesses down to profitable businesses and adequately utilizing debt finance with low capital cost in one hand, and bold exploration investments (in R&D, business development, M&As, etc.) by using rich operating cash flow (equity finance) generated from exploitation in another hand – This is a modern "ambidextrous" strategy which integrates business and finance.

Meanwhile, we should decisively get rid of certain terrible nonsense, which was much told in the business world in Japan: "If a company focuses on short-term profit, it will not be able to make long-term investment, and therefore, lose growth potential." This remark fails to understand the difference between the concept of accounting profit and the concept of cash flow. In the era of intensified global competition and disruptive innovation, along with disruptive black swan events, rich operating cash flow is the source of growth potential, competitiveness, sustainability, and resilience of companies. The Code should further emphasize this point.

4. **Strong earnings power (especially operating cash flow) also supports ESG/SDG management**

It is undisputable that ESG/SDGs is now important for both business management and selection criteria of institutional investors. However, we should be cautious about discussions

referring to trade-off with earnings power without careful consideration. An absolute requirement for companies to contribute to such social and global value is strong and sustainable earnings power, especially, operating cash flow which allows for self-funded investments. With that, companies can make sustainable investments in ESG/SDGs. Companies without “earning power” fall into a situation where “poverty dulls the wit”, and cannot conduct business by putting such a philosophy in the center. Dr. Yutaka Nakamura proposed “Japan Sun Industries (*Taiyo no ie*)” aiming at enabling employment of people with physical disabilities, and OMRON was the first company which committed to it. I have served as an outside director of OMRON for 10 years. Because it conducts business with such a high philosophy, OMRON placed an emphasis on high earnings power based on ROIC management and sophisticated governance. The relationship between ESG/SDG management and pursuit of earnings power is characterized as trade-on.

We should never allow a short-sighted view that regards ESG/SDG management as a contrary concept to management based on shareholder value supremacy, and shifts a discussion to justify low-earnings management. Such a shift of attention may endanger ESG/SDG management itself. In the first place, Japan’s Corporate Governance Code does not stand on the shareholder value supremacy. Instead, its basic philosophy is sustainable increase in corporate value for all stakeholders. It is totally synchronized with recent discussions on ESG/SDG management.

5. Restriction of parent-subsidiary listing and clarification of controlling shareholder’s obligations to protect minority shareholders

In the past few years, with respect to parent-subsidiary listing, what drew our attention was conflicts between interest of a parent company (controlling shareholder) and interest of a subsidiary company and its minority shareholders, which resulted in disputes.

There was criticism of parent-subsidiary listing in terms of its form in the past. However, looking at the economic reality, if parent and subsidiary companies have a closer business relationship regardless of the form, conflicts of interest between parent and subsidiary companies are more likely to occur. As a result, a conflict of interest occurs between the parent company and minority shareholders of the subsidiary company, and leads to a dispute, thus damaging corporate values of both companies. This is problematic.

In the past era of constant growth with limited cases of transformation of operating models and industrial structure due to disruptive innovation, there were considerable parent-

subsidiary listings upon spin-offs of new growth businesses, in order to accelerate growth of such businesses by providing flexibility in organizational management and strategy, and allowing for autonomous management. In that sense, there used to be positive sides of parent-subsidiary listings, including increased corporate value, for the economic growth. Nonetheless, currently, there are many cases of parent-subsidiary listings which have not really achieved growth for a long time. Besides, when both parent and subsidiary companies need to undergo drastic CX to respond to a rapid and significant change in the business environment, such issues as conflicts of interest attributable to their relationship often hinder a bold and prompt strategic pivot. Many of recent disputes originated from such a context. In other words, parent-subsidiary listings now reduce strategic freedom and strategic promptness of listed companies, and thus, the risk of reducing their CX capabilities is greater than benefits.

I believe that we should not approve parent-subsidiary listings, except in such transitional cases as the one in the course of a spin-off of a growth business which is very different from core businesses, or the one in the course of separating a business to reorganize a business portfolio. As a legal principle commonly used in the US and Germany for that purpose, the Code should clearly state the controlling shareholder’s obligations to protect the interest of minority shareholders (so-called fiduciary duty).