Provisional Translation

Opinion Statement for the 22nd Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code

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The draft statement as an interim opinion suggests ways of further enhancing board effectiveness, with a focus on the ratio of outside directors of companies mainly in the "prime market," which compete on the global stage in terms of their business and their profile on the capital markets, as well as the enhancement of Nomination (Advisory) Committee. The draft opinion statement also encourages companies to ensure diversity, placing importance on maintaining a diverse pool of future top management candidates, rotation and replacement of executive members in particular, and also focusing on the ratio of mid-career hires. I believe that all these points are vital, and sincerely hope that the Code will be revised accordingly, thus facilitating such achievements.

As the corporate governance reform has entered the phase of shifting from form to substance, the Corporate Governance Code should also encourage the advancement of the effective reform, and the key is the functions of the board. As has been stated previously, the board should perform a function of appointing outstanding top management, who can demonstrate strong and robust leadership in times of crisis and disruptive innovation, on a timely and appropriate basis. While appointing and supporting a strong leader, the board must also perform a function of promptly dismissing the strong leader who fails to fulfill their remit or falls short of expectations. To that end, both inside and outside directors should have the capabilities, insight and motivation to undertake this long-term mission from a company-wide perspective. To improve the quality of leadership candidates who can successfully deal with periods of disruption and discontinuous changes, as well as high quality executive management candidates to support these leaders, it is essential to have the talent pool over the long term, which consists of people from diverse backgrounds, with broad management experience beyond the company's existing businesses, and a career history of dealing with adverse circumstances in previous roles. However, the majority of management teams at large Japanese companies and even the next generation behind them tend to be overwhelmingly middle-aged Japanese who joined the company as graduates. Management ranks tend to be homogeneous, closed and rigid compared to the U.S. and Europe, or even emerging economies. In terms of rapid, bold decision-making, this type of management structure is inevitably a major organizational weakness for Japanese companies, particularly against the backdrop of a discontinuous, uncertain, global business environment.

Most prime market constituents are likely to operate in competitive domains that are vulnerable to global devastating crises and disruptive innovation through digital transformation. Therefore, it is critical that Japanese companies overcome this weakness. This should naturally be helped by these revisions to the Corporate Governance Code.

With respect to the other remaining issues, there should be further discussion of how to improve companies' "earnings power," especially in relation to group governance (parent-subsidiary listing issues) and ESG/SDG policies.

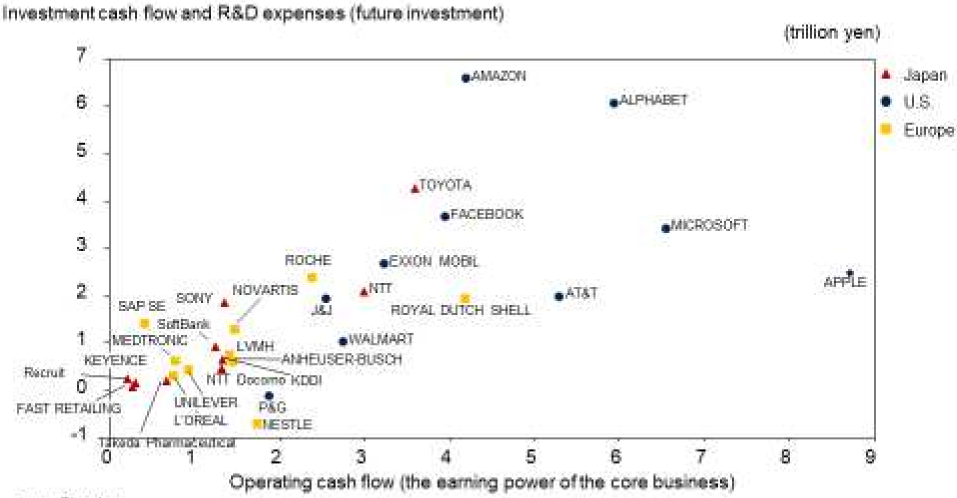
For the former, the disciplinary principle of parent-subsidiary listings remains unclear. The response so far has been quite piecemeal and this complicates companies' decision-making process. This has become a key factor impeding speedy and dynamic strategic decision-making by the board, which should be regarded as of fundamental importance. If the principle that controlling shareholders should uphold the rights of minority shareholders is applied as the norm, the issues are more clearly defined. Companies then have a choice on whether or not to strategically undertake a parent-subsidiary listing in return for complying with the norm.

Regarding the latter, as is clear from the attached chart, the future investment capacity of top-ranked companies today is largely defined by the earnings power of their core business. Without the earnings power to back it up, a company's commitment to ESG and the SDGs, which are essentially investment for the future in nature, is just an unsustainable pipe dream. In this sense, the earnings power of Japanese companies remains relatively weak. The gap between Japanese and US companies in this respect is huge. First of all, it is essential that the Code encourages companies to improve earnings power, especially operating cash flow (or EBITDA) which is a real measure of earnings generation capability.

It has long been pointed out that Japanese companies are not making effective use of their retained earnings. Because Japanese companies have such low levels of operating cash flow, they are fearful of drawing down what little accumulated income they have in case it is needed for an emergency. This seems to be the underlying thinking here. The world's leading companies earn vast operating cash flows (trillions of yen) from their core business. This is essentially equity (as opposed to debt which has to be repaid). This allows them to actively make higher risk investments in future in areas such as R&D, M&A as well as longer-term ESG initiatives and SDGs. This difference is at the heart of the retained earnings issue. It really just comes down to earnings power.

Operating Cash Flow and Investing Cash Flow + R&D Expenses of the Top 10 Market Capitalization Companies in Japan, the U.S. and Europe

◆ **In the era of disruptive innovation, the earning power of the core business will define future investment power and SDG/ESG investment power.**



Source: Bloomberg