Provisional translation

Opinion Statement for the 27th Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code

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Kazuhiko Toyama
Chairman of IGPI Group
Industrial Growth Platform, Inc. (IGPI)

1. Issues related to the substance and effectiveness of corporate governance reform

- **The biggest challenge in realizing governance reforms is to ensure the quality of the people who lead the reforms.**
  - Quality of independent directors
  - Quality of human resources on the executive side (especially top management and the board secretariat)

- The quality of the management and the quality of the governance function (Board of Directors) that selects and oversees the management have to be extremely high in order to 'enhance' corporate value, and this is especially true if looking to promote growth in the era of disruptive innovation.
  - The ability to identify capabilities of the management (his/her capability to identify risks that should be taken by the company, and to assess its portfolios of businesses and functions in a dispassionate manner)
  - The ability to identify the potential of management candidates
  - The ability and commitment of independent directors and inside directors to do so

- The number of problem areas that can be resolved by further revisions and detailing of the Code is decreasing, and more effort should be focused on other measures to improve the quality of leaders.
  - The risk that formal requirements in the Code may lead to a neglect of substance (a typical patter is an increase in quantity [of outside directors] at the expense of quality) → Have occasionally come across cases where those whose careers as corporate employees were not as successful as they desired now serve as outside directors of other companies, and earn an extra money by talking about their "past glories (?)"
  - With respect to the TSE's independence criteria, stricter requirements are needed in some areas, and easing is required in some other areas, from the perspective of substantive competence and conflicts of interest. → **Instead of independence criteria as minimum requirements, model outside director eligibility criteria should be established in a way to contain more substantial requirements and constitute best practices for the Prime Market (unlike the Code, "comply or explain" approach does not apply)**
  - Widening the range of candidates for outside directors by including current top managers of other companies, while raising the bar for eligibility requirements in combination with training

programs and other measures.

- Need a system to companies to question companies about the substantive quality of the management and managers in more essential areas, rather than just discussing formal skillset.

2. Challenges of governance reform to eliminate a tendency for underinvestment

- The root of the problem of retained cash and underinvestment in human resources lies in the fact that the industrial and business models of Japanese companies are in large part based on mass-production and mass-sales that rely on tangible capital investment. These models are outdated and fragile, having been left behind in the age of knowledge-intensive, disruptive innovation.

  - Aware of the fragility and low profitability of their existing business model, companies are tempted to hoard cash and cash equivalents for "what if" scenarios

  - In the tangible asset model, labor costs are primarily regarded as costs, so when companies make investments, the priority is inevitably given to capital investment [rather than investment to human resources]

- **The investment model is no longer continuous as in the past, when additional capital investment was made in blast furnaces because more and more iron was being sold, or additional capital investment was made in TV factories because more and more TVs were being sold. Instead, our era requires uncertain investments in discontinuous areas, such as the search for new growth opportunities, innovation investments, and acquisitions to obtain new organizational capabilities needed to transform business models. With this in mind, the question will be how to encourage high-risk future investments.**

  - We are faced with a chicken-or-egg dilemma of whether to build resilience first through business model transformation or make investments first for business model transformation. → We should focus on what governance reform can accomplish in this context.

3. Positioning of the Revision of the Stewardship Code

- I do not see major issues in the Stewardship Code under the context of the current debate on new capitalism.

- **Rather, the challenge for institutional investors, in corporate governance, is the risk of a decline in the quality and quantity of people in charge of engagement, and our focus should be on this issue.**

  - While passive management is becoming a mainstream strategy, institutional investors' loss of motivation to engage with individual companies will be a problem.

  - Conversely, as the role of governance becomes more sophisticated, the competency requirements of people in charge of engagement also become more sophisticated.

  - Ultimately, how to respond policy-wise to the trend of raising the bar to effective engagement will be another difficulty beyond the scope of the Stewardship Code.