What Needs to be Added to the "Action Program for Accelerating Corporate Governance Reform: From Form to Substance"

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(The following is my personal opinion and not that of any organization.)

As sent to prospective candidates to be the next Prime Minister, in no particular order:

Chief Cabinet Secretary Yoshimasa Hayashi, Minister for Foreign Affairs Yoko Kamikawa, Minister of Economy, Trade and Industry Ken Saito, Minister for Digital Transformation Taro Kono, Minister in Charge of Economic Security Sanae Takaichi, Secretary-General of the Liberal Democratic Party Toshimitsu Motegi, House of Representatives Member Shigeru Ishiba, House of Representatives Member Shinjiro Koizumi, House of Representatives Member Takayuki Kobayashi, House of Representatives Member Seiko Noda, House of Representatives Member Katsunobu Kato.

CC: Prime Minister Fumio Kishida, Deputy Chairman of the Liberal Democratic Party's Political Research Committee Masahiko Shibayama, Parliamentary Vice-Minister of Health, Labor and Welfare of the Liberal Democratic Party Akihisa Shiozaki, Deputy Secretary-General of the Liberal Democratic Party Seiji Kihara, House of Representatives Member Kenji Nakanishi.

Japan's Corporate Governance Code (CGC) and the investor Stewardship Code need to function as "two wheels" of a cart. I had advocated this since 2013[1], and when I had the opportunity to formerly propose the establishment of the CGC to the Liberal Democratic Party in 2014, I insisted that the most important thing was to "promote the disclosure of information that enables one to verify governance structure and substance" at firms.

"Governance and oversight are more likely to function effectively on a board that has a majority of truly independent and qualified independent directors." As of 2014, this dynamic had been recognized in many countries around the world. At the time, I thought that if companies disclosed their actual governance practices and stewardship by investors started functioning well, Japan, as a developed country, would naturally adopt a similar stance within the next five years or so.

Ten years later, however, there is still no serious discussion of these two issues in Japan. Now that global investors are paying more attention to the Japanese stock market, I believe it is time for us to confront these core issues and take the following steps to speed up Japan's governance transformation.

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[1] Please refer to the document link in the Japanese blog post 「私が 2013 年に「ダイバーシティ」に取り組むガバナンス・コードを提案するに至るまで」 at: https://blog.bdti.or.jp/2023/12/02/cgcp/ entitled 「予算が要らない、最大に評価される三本目の矢」 (The same document can be found in "How Japan's Corporate Governance Code Was Born," at: https://blog.bdti.or.jp/en/2015/03/15/cgcodejapanbirth/ .

Appoint a Majority of Independent Outside Directors

The average PBR of a company listed on the Prime Market is around 1.5, and the average total shareholder return (TSR) from 2014 to 2023 is only about 8%. However, for companies with six or more outside directors, these figures rise to 2.07 and 8.6%, respectively. In companies where the majority of directors are reported as "independent outside directors" by the company's own standards, these figures rise once again, to 2.29 and 9.3%. Furthermore, if we look only at companies where more than 40% of directors would be judged to be "independent" according to the (more stringent) TSE independence criteria, these figures rise again to 2.57 and 10.5%, which is well above the average for the entire Prime Market.

Clarify the Meaning of "Corporate Value" and Responsibility of the Board

The FSA's Action Program, in response to the TSE's request for management to be conscious of the cost of capital and the stock price, calls for follow-up measures to ensure that listed companies go beyond mere formalities and manage their businesses with an awareness of profitability and growth. However, the current CGC does not clearly define "corporate value," and moreover, the role of the Board of Directors in consciously seeking to raise the stock price remains ambiguous.

In the CGC's fourth Basic Principle, entitled "Responsibilities of the Board of Directors," a clear definition of "corporate value" (企業価値) should be established based on the "Guidelines for Corporate Takeovers" set forth by the Ministry of Economy, Trade and Industry (METI) on August 31, 2023. These guidelines clearly state that "from the perspective of capital financing sources, corporate value can be expressed as the sum of shareholder value (market capitalization as valued in the market) and net debt value."

In addition, it should be clearly stated that the Board of Directors has an important role to play in increasing market capitalization--that is, the stock price, which is the main driver of corporate value--over the medium to long-term. This is often not clearly understood even in dialogue with shareholders.

Disclose Annual Director Training Results

The number of newly appointed outside directors has increased. As a result, many directors are inexperienced and have never received any training. Japan is now facing a serious "lack of experience and knowledge" on its corporate boards.

In mid-2014, I submitted a memo advising the FSA on the contents of the CGC. I wrote the following:

> "Director and kansayaku training: All incoming directors and kansayaku should obtain comprehensive and tailored induction when they join the Board. This

> should include their fiduciary duties and liabilities and how to discharge those duties, and an orientation program to ensure that they are familiar with the company's business and governance practices. For directors and kansayaku who have never served on the board of a public company, the company should provide third-party professional training in corporate law, securities law, accounting, finance, M&A, risk management and controls, and governance best practices; and other legal, audit and industry-specific knowledge as appropriate."

Unfortunately, the drafters of the CGC did not adopt the phrase "should obtain," but rather "should provide and arrange training opportunities and support for their expenses." This gives the impression that the minimum a company need do is to declare a policy of "providing 'opportunities" in the sense that they will then reimburse any training costs <u>if</u> there are any directors who humbly ask for it. Such a "policy" is different from "actually having them attend training."

In the same memo, I further proposed: "Each year, the company should disclose… a summary of the director and kansayaku training (or preparatory training) that was given in the prior year." If this requirement had been incorporated into the CGC, the problem of "lack of experience and knowledge" on corporate boards would not be as big as it is now.

Plan for Convergence of the Three Governance Structures of Listed Firms

No other developed country has seen such confusion and ineffective engagement with investors as has been caused by Japan's use of three separate legal governance structures. To set the groundwork for convergence, the following steps should be taken:

- Companies with an Audit & Supervisory Board and companies with an Audit & Supervisory Committee should also have legally-defined "executive officers" (執行役) who bear a duty of due care under the Companies Act. This is something I proposed early on, and the same opinion was set forth in a memo that METI submitted to the Legislative Council of the Ministry of Justice in 2017. In particular, even in the case when a company with an Audit and Supervisory Committee "delegates [broad] management authority to executives," the Companies Act does not require the appointment of such legally-defined executive officers, notwithstanding that the objective is to implement the "monitoring model" of governance. This is in contrast to the fact that Nomination Committee-Style [3-committee] firms, which are also intended to implement the monitoring model, specifically delegate such management authority only to legally-defined executive officers, thereby deliberately separating the supervisory and business execution functions of governance. This discrepancy must seem strange to investors trying to understand the law. When a company's board delegates broad authority to management, the persons whose authorities have increased significantly should be obliged to exercise a heavy legal duty of due care.

As stated in the memo submitted by METI to the Legislative Council[2], the problem of "just a title" "executive officers" (執行役員) and others who are actually considered "employees" under the Companies Act being appointed to carry out business operations, and the accompanying reduction in the number of executive directors who are bound by a duty of care, is a problem now occurring throughout the Japanese market.

- In the case of a Nomination Committee-Style [3-committee] firm, if the majority of the Board of Directors is made up of independent directors who meet the TSE's independence criteria, it should be made possible for the full board to vote to alter the appointment and dismissal proposals decided by the Nomination Committee. Otherwise, the CEO may influence the composition of the Nomination Committee (the selection of its members) behind the scenes, impairing the objectivity of the Nomination Committee and the end result.

Promptly Disclose Stock Transactions by Directors and Executives

In Japan, if a director of a listed company buys or sells shares in that company, investors will not know about that transaction until the next annual financial report mentioning his or her holdings is filed—which means they may have to wait up to one year.

In the United States, by contrast, this information must be reported to the SEC, and the details are made available to free sources such as Yahoo! Finance. Large sales of company stock by management are perceived as a negative signal by the stock market. Therefore, the prompt disclosure of such information can enhance the efficiency and transparency of the market as a whole.

It is strange that such valuable information is not promptly made public in Japan.

Enhance Disclosure on Beneficial Shareholders

Information disclosure by investors also needs to be expanded. In the United States, it is not only are the top 10 largest holders of listed companies routinely disclosed, but institutional investors managing large amounts of assets (for example, 15 billion yen or more) are required to disclose detailed information on their holdings every quarter (including investments of less than 5%), and the details are made available to the public.

As a result, in the United States, anyone with access to the Internet can freely find out who the beneficial shareholders and major owners of a listed company are, as well as what percentage of the shares are held by institutional investors. This also provides extremely valuable "signal" information.

Like information on stock trading by executives, such broad disclosure of beneficial

[2] "Awareness of issues regarding discipline related to corporate governance, etc." (April 26, 29) https://www.moj.go.jp/content/001237422.pdf .

shareholders enhances the efficiency and transparency of the market as a whole. However, it is very difficult to collect this kind of information in Japan. If this kind of information *were* available (e.g. on EDINET), retail investors would be able to invest with greater confidence in medium-sized listed companies because they could confirm the presence of institutional investors. This policy of "disclosure rules that make it easier to invest" is one of the strengths of the U.S. market. This kind of information should be made public in Japan as well.

Further Strengthen Disclosures that Increase Stock Market Efficiency

As pointed out above, information on large beneficial shareholders should be made public on EDINET. In addition the following items should be considered: (a) in addition to information on the top 10 largest holders, information on stock holdings by investors who manage a large amount of assets (e.g., 30 billion yen or more) should be registered and disclosed to the public without undue delay; (b) transaction information of large investors who frequently buy and sell in large blocks should be registered and disclosed without delay; (c) registration of, and disclose to the public of any transactions made by, persons who are considered to be “insiders” (directors, executive officers, lawyers, and other advisors of the company).

In the United States, such rules are already in place, so this information is easily accessible to individual shareholders and institutional investors on Yahoo! Finance, for example. I don't understand why the FSA doesn't require such information disclosure. If it were made available on EDINET, anyone could access it through Yahoo! Finance-Japan. It is precisely because we are in an era of “dialogue” and NISA that these reforms are indispensable for improving the efficiency of the market.

Improve the Comparability of Proxy Voting by Institutional Investors

As a general rule, the Stewardship Code (SC) requires asset managers to disclose the results of their proxy voting for each individual proposal for each of the securities they hold (Principle 5-3). However, currently there is no uniform format for this data, and it is not centrally managed. This state of affairs makes it very difficult for asset owners to analyze and compare proxy voting by asset managers, and therefore constitutes an obstacle to revitalizing the investment chain.

If this situation continues, the value that was expected from such SC disclosures will not be realized. The data should be centrally managed in EDINET in a unified format.

Enact a Japanese Version of ERISA to Protect Pension Beneficiaries

In Japan, there are no laws that regulate asset owners and managers to protect corporations and other pension beneficiaries in the way that ERISA in the United States does. Moreover, enforcement of existing laws by the Ministry of Health, Labour and Welfare is weak. Some may remember that after the AIJ incident, the LDP's investigative committee proposed a “Japanese version of ERISA.” I have also been advocating this to politicians, the Ministry of Health, Labor and Welfare, and the Prime Minister for about 20 years, and I still believe that a "Japanese version of ERISA" is necessary.

The enactment of a Japanese version of ERISA would clearly instill the concept and awareness of fiduciary duties imposed on asset owners and asset managers, as well as address the issue of conflicts of interest within Japanese corporate groups. It would establish legal standards applicable to "asset management" that are clearer and stricter than those applicable under general fiduciary contracts.

A Japanese version of ERISA would also bring the following benefits:

- It would give beneficiaries the right to sue the pension fund's board members or asset managers directly, whereas currently only indirect claims can be brought, by requesting that the company sue [a request which does not need to be heeded];

- As ESG investment methods along with private equity and venture capital investment opportunities continue to grow at an accelerating pace, adopting a "prudent man rule" like that found in ERISA would explicitly recognize these as contributing to the beneficial diversification of a portfolio.

- In the annual financial report, among the cross-shareholdings, "deemed cross-shareholdings" include assets in trusts that have been allocated for retirement allowance [taishoku-kin] payouts, and it is said in some cases even corporate pension assets are also held in such trusts. In either case the voting rights are usually controlled by the parent company. If this is the case, the company (and pension fund, if applicable) should clearly disclose to investors and beneficiaries the details, reasons and justifications.

If there were a Japanese version of ERISA, it would be a violation for the parent company to control the voting rights in the case of pension funds, because the Avon Letter rule--a rule that requires voting rights to be exercised in accordance with fiduciary duty--requires the pension fund (as asset owner) and its entrusted managers to actively fulfill and exercise their fiduciary responsibilities.

The same principles should also apply when retirement allowance assets or corporate pension assets are placed in a trust. Annual financial reports should be required to disclose whether the company controls the exercise of voting rights or whether an independent third party controls the exercise of voting rights and stock selection. Since "retirement allowances" are a system that is unique to Japan, the Japanese version of ERISA should also cover such cases of asset trusts for them.

Improve the Machine Readability of Disclosure Documents

The current Tokyo Stock Exchange (TSE) insists on the need to improve the "quality" of information disclosure. It seems that it is declaring this in good faith, but if the stock exchange is fully prepared to face this issue with sincerity, it should amend its XBRL taxonomy for the “Corporate Governance Reports” that companies must submit to the TSE subdivides the “disclosure items” such that each can be individually identified and “read” by computers.

As it currently stands, disclosures on more than 11 different topics, such as policies on compensation and nominations, are all bundled together and stuffed into a single XBRL tag. Because of this, it is impossible to consistently separate out each disclosure item, making it extremely difficult to perform comparative analysis across multiple companies.

As a result, although the idea of “two wheels” of a cart and “comparative analysis” was the very starting point of the CGC, there has still not yet been sufficient analysis and comparison by investors. Because rigorous comparative analysis has not been conducted on these items, which are paramount to achieving the CGC's objectives, the content and quality of information disclosure by listed companies remains insufficient. Against this backdrop, investors are quite understandably saying that there is no point in rigorously analyzing such low-quality disclosures. This is nothing but a vicious circle. In the age of big data, the current situation is not aligned with the direction that the TSE should be aiming for.

I fervently hope that Japan's leaders will move away from their traditional inward-looking tendencies, learn quickly from other countries' capital markets, and accelerate reforms by addressing these essential challenges.