

# **ICGN-METI Discussion**

**October 2022**

**Corporate System Division  
Corporate Accounting, Disclosure and CSR Policy Office  
Human Resources Policy Office**

# **1. Revision of CGS Guidelines**

# Positioning of guidelines published by METI

Hard law

Law  
(Companies Act,  
Financial Instruments  
and Exchange Act etc.)

Corporate  
Governance Code  
(TSE)

Practical Guidelines  
in accordance with the CG code

Revision of  
2022/7

Practical  
Guidelines  
for  
Corporate  
Governance  
Systems  
(CGS  
Guidelines)

Practical  
Guidelines  
for Group  
Governance  
Systems  
(Group  
Guidelines)

Practical  
Guidelines  
for Business  
Transformat  
ions

Practical  
Guidelines  
for  
Independen  
t Directors

Soft law

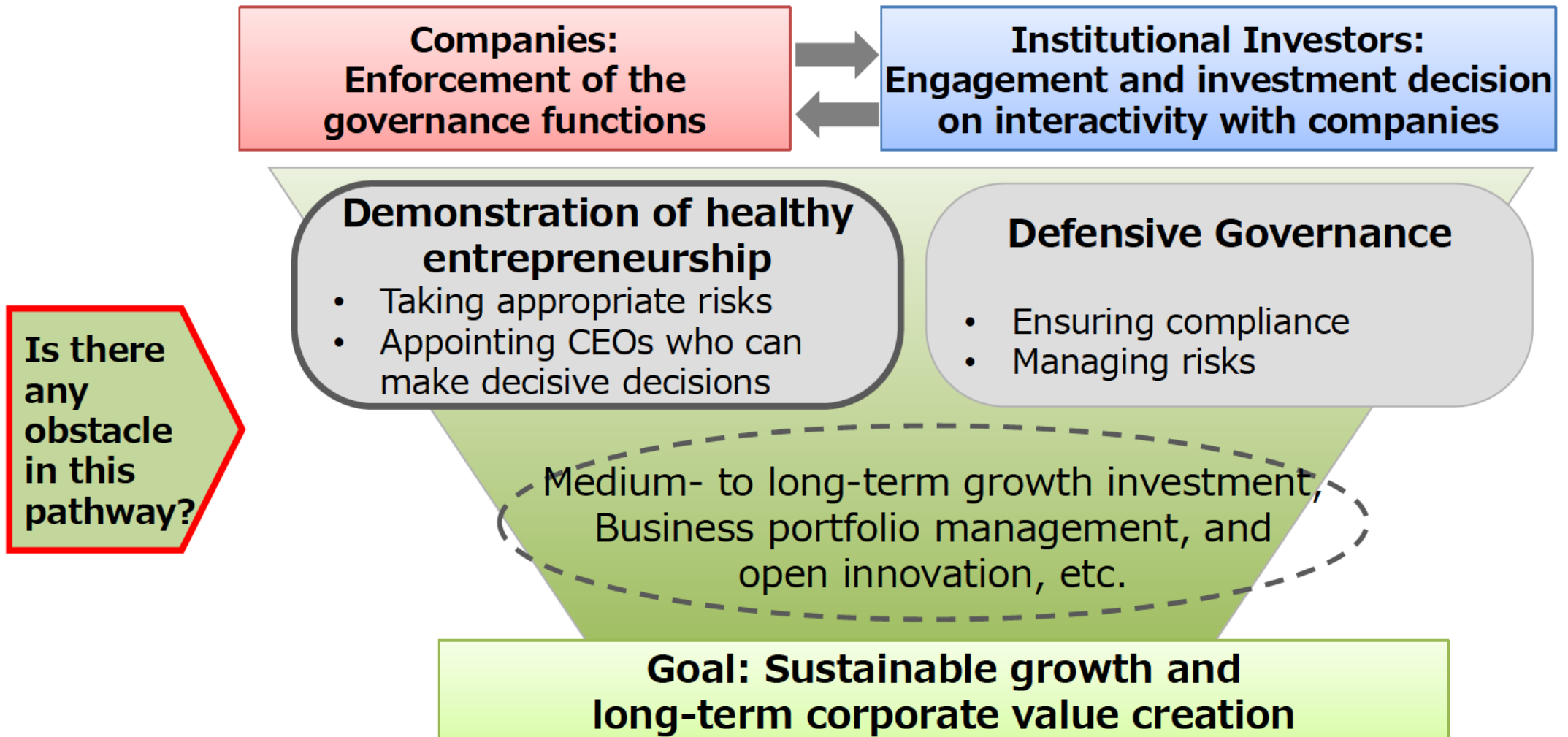
Main  
Target

All listed companies	Listed companies with group management	Large scale, diversified, and globalized listing companies	Directors of all listed companies
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To enforce Corporate Governance Reform from "formally" to "practically"

# Goal and pathway of the corporate governance reforms

- Through enforcement of governance functions and interaction between companies and capital markets, corporate governance reforms will lead to sustainable growth and long-term corporate value creation through promoting healthy entrepreneurship.



# Strengthening both executive and monitoring functions

- In addition to strengthening monitoring functions, it is also important to strengthen executive functions (leadership of management).
- In order to improve governance reform efforts practically, **it is important for companies to work consciously to strengthen both their executive and monitoring functions synergistically.**

## Promotion to strengthen functions synergistically

**Executive  
(management)**

**Monitoring  
(Board of Directors)**

[Relationship]

- ① **Formulating management strategies jointly with each other**
- ② **Influencing each other in the governance system**

- The success of bold management reforms depends mostly on “Top Management Power”
- Executive systems that support leadership of management are also needed

- Selects outstanding managers and encourages them to manage the business with awareness of increasing corporate value
- Changes the mindsets of outside directors and improves their qualities

# The Meaning of “Monitoring” in the Board of Directors

1

- The core of the “monitoring” expected of the board of directors will consist of evaluating performance and judging the propriety of management activities through nomination and compensation decisions, in light of the basic management policies and strategies formulated by top management and approved by the board of directors themselves.

2

- The “Monitoring” does not simply consist of things like reining in executive decisions and uncovering misconduct but also includes encouraging appropriate risks to be taken and internal management reforms to be made, and drawing attention to the risk posed by not taking risks (i.e., the risk of inaction).

3

- The board of directors must also be aware of how the capital markets view the company and understand how favorably its corporate value is rated by them. So, it is also important to keep in mind whether the shareholders and other stakeholders will benefit, especially when outside directors perform monitoring functions.

# Choice of governance systems

- The CGS Guidelines presents **two models of the board of directors and indicates the direction of each.**
- The Guidelines state that companies **should ideally make choices** regarding which governance system to adopt and which organizational design is appropriate for it, and ensure they can **explain the reasons for them to the shareholders and other stakeholders.**

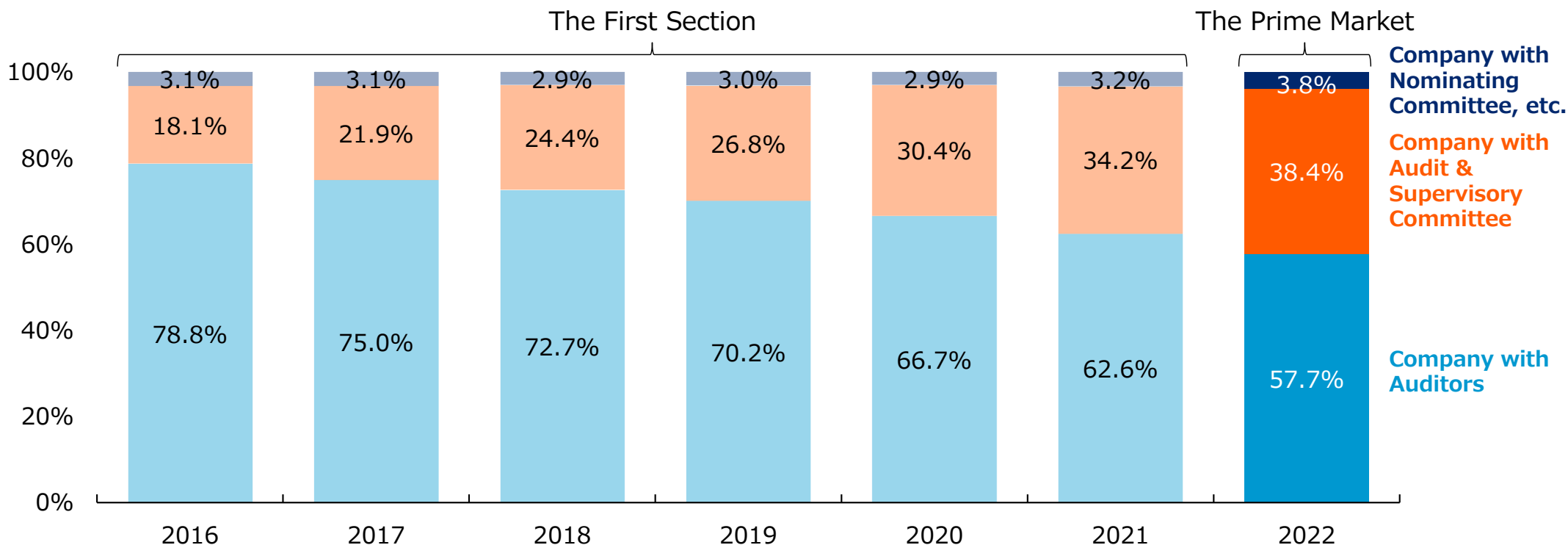
## Typical models of boards of directors

	<b>A</b> One oriented toward having the board of directors specialize in monitoring	<b>B</b> One oriented toward strengthening the monitoring both within and outside the board of directors while emphasizing its decision-making functions
Organizational Design	Typically, a Company with a Nominating Committee, etc., Company with an Audit and Supervisory Committee.	Typically, a Company with Auditors.
Delegation of Authority	Decisions on the execution of individual business actions are largely delegated to the Executive.	Less important matters for decisions on the execution of individual business actions are delegated to the Executive.
Constitution	Mainly outsiders	Mainly internal executives (on the other hand, a certain number of outside directors are appointed to ensure monitoring functions)

# Ratio of three forms of corporate organization

- The number of Companies with an Audit and Supervisory Committee has increased to the point where more than one-third of the companies listed on the Prime Market of TSE have such a committee.
- The CGS Guidelines state that **governance systems which emphasize the monitoring functions are beneficial for promoting management to take risks and relativizing internal logic.**

Forms of corporate organization of companies listed on the first section and the Prime Market of the TSE



(Note) Targeting companies listed on the first section of the TSE (2016 to 2021), the Prime Market of the TSE (2022).

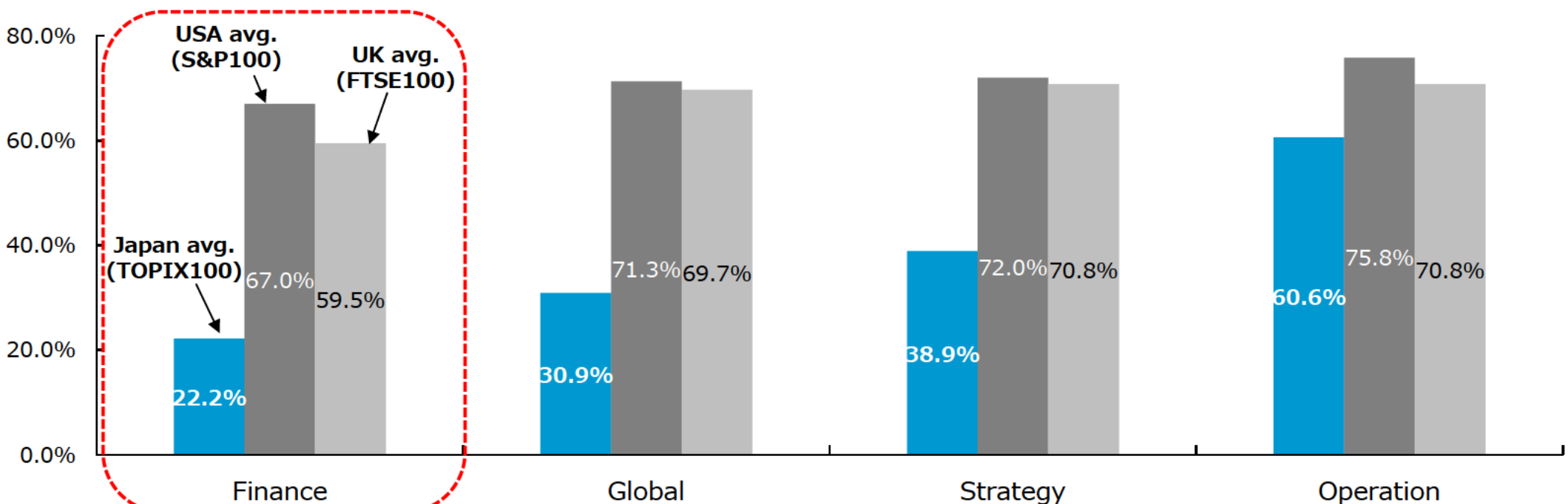
(Source) Japan Association of Corporate Directors (August 2021), EoL (July 2022).



# Nominating directors based on the company's issues

- In particular, important issues for many Japanese companies are the need to increase their mutual understanding with the capital markets and shift their management focus toward emphasizing efficiently allocating management resources.
- The CGS Guidelines state that one possible option is to select outside directors who have sufficient knowledge, experience, and abilities regarding capital market-aware management.

## Skills of Board Members (comparison between Japan, the USA and the UK)



(Note) % = number of the board members that have particular skills / total number of board members .

(Source) The Japan Research Institute.

# Nominating “people related to investor shareholders” to be directors

- When nominating “people related to investor shareholders” to be directors, due care must be taken regarding matters like conflicts of interest, information control, independence, externality, and disclosure.

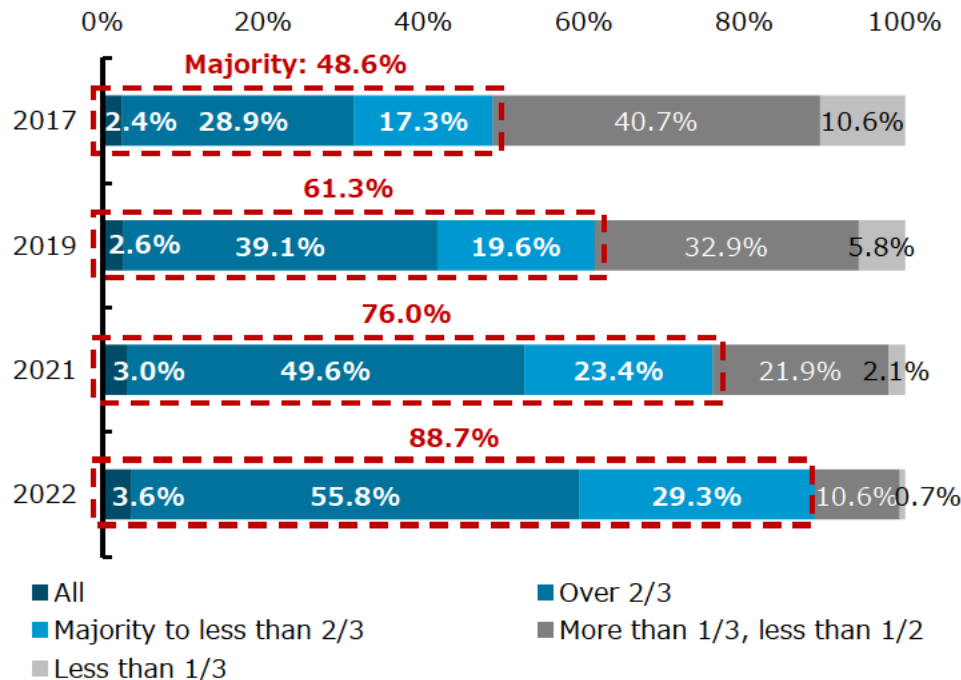
## Points of view / Measures to be considered when nominating “people related to investor shareholders” to be directors

- 1 Disagreement with General Shareholders**
  - Disagreement with general shareholders can become a problem when the time horizon about investment between the investor and general shareholders is different.
  - The board of directors and nomination committee should consider whether it is appropriate to nominate “people related to investor shareholders” to be directors.
- 2 Conflicts of Interest with the Company**
  - If there are conflicts of interest between the director and company, it is necessary to consider measures to exclude the director from deliberations / decisions of board of directors.
- 3 Information Control**
  - Information control can require special consideration because the directors inevitably know important information.
  - It is especially important to ensure that investor shareholders comply with insider trading regulations and impose confidentiality of important information before publication and prohibition of trading.
- 4 Independence, Externality**
  - If nominating investor shareholders to be directors, disclosure regarding the fact that the directors belong to investor shareholders should be made.
- 5 Disclosure about Important Contracts**
  - When making consensus, such as settlement agreements, both companies and investors should disclose appropriate information.

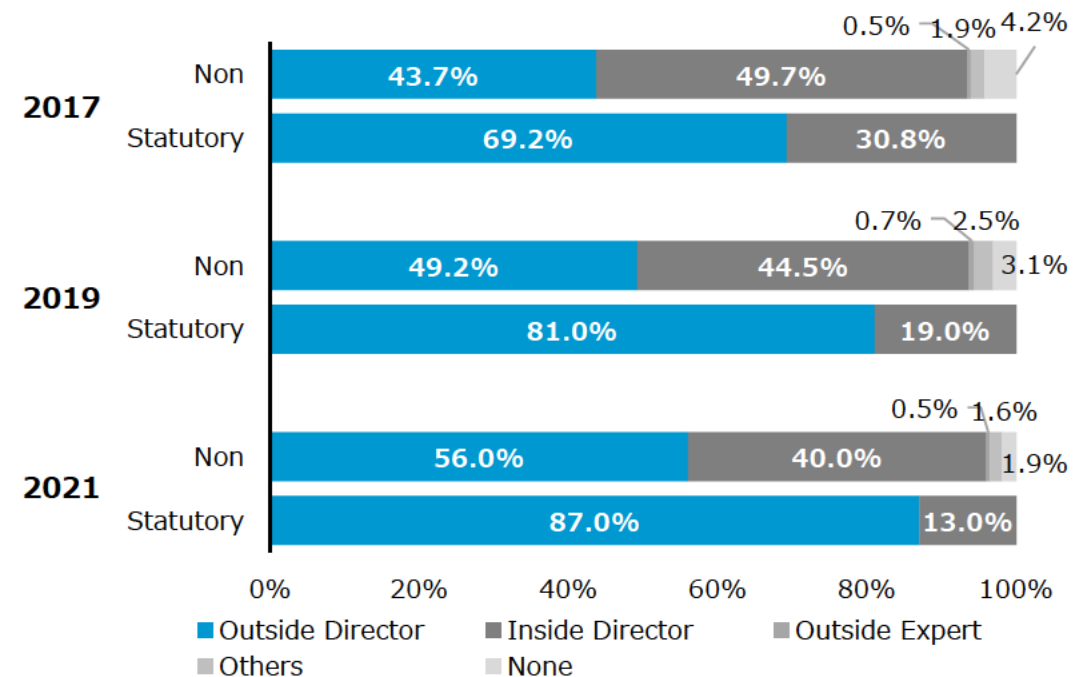
# Nominating / Compensation committee members and chairpersons

- The ratio of outside directors in Non-statutory Nominating Committee has increased. Directors make up the majority of committee members in more than 85% of companies listed on the Prime Market.
- For non-statutory nominating or compensation committees, **consideration should be given to appoint outside directors for the majority of the members and for their chairpersons.**

## Ratio of outside directors in Non-Statutory Nominating Committees



## Chairpersons of Nominating Committees (Statutory / Non)

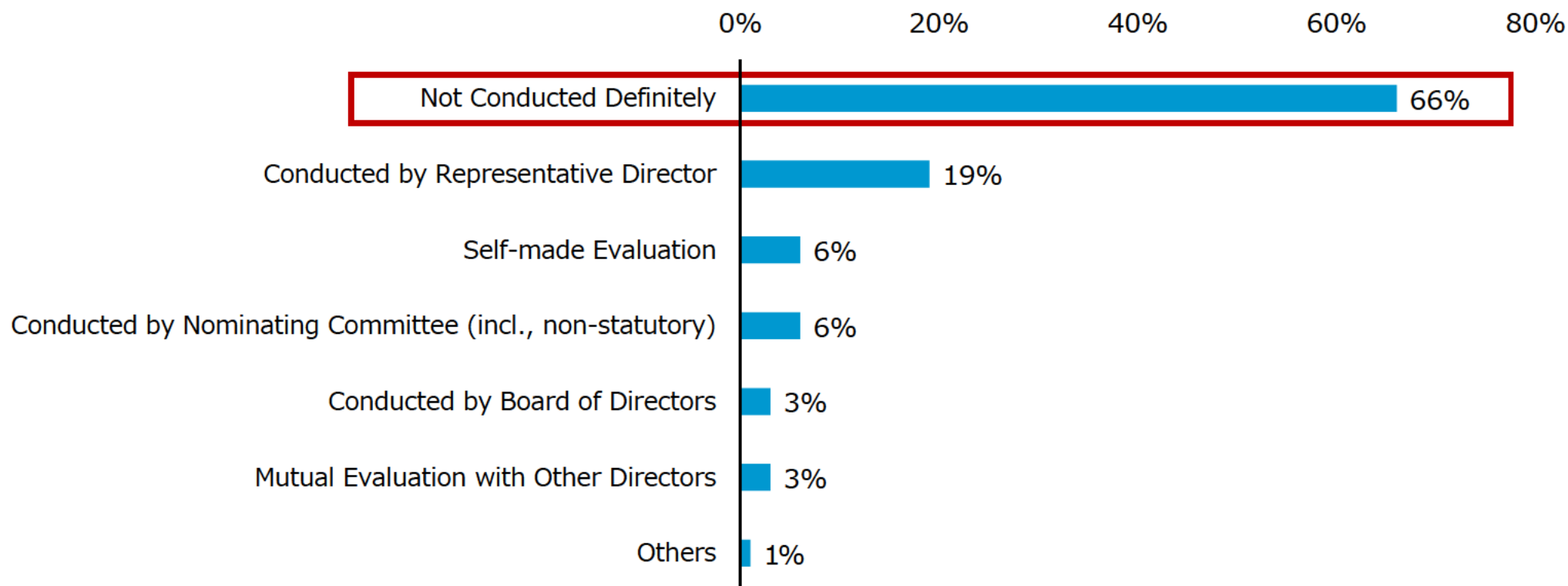


(Note) Non=Non-statutory. Targeting companies listed on the first section of the TSE (2017 to 2021), the Prime Market of the TSE (2022).  
 (Source) TSE (August 2022).

# Evaluation of outside directors

- Japanese companies tend to not conduct evaluations for outside directors definitely and best practices for evaluation of them are not entirely established.
- In the guidelines, **we stipulate best practices for evaluation of outside directors**, such as interviews for mutual evaluations conducted by the chairpersons of nominating committees who are also outside directors.

## Ways of Evaluation for Outside Directors

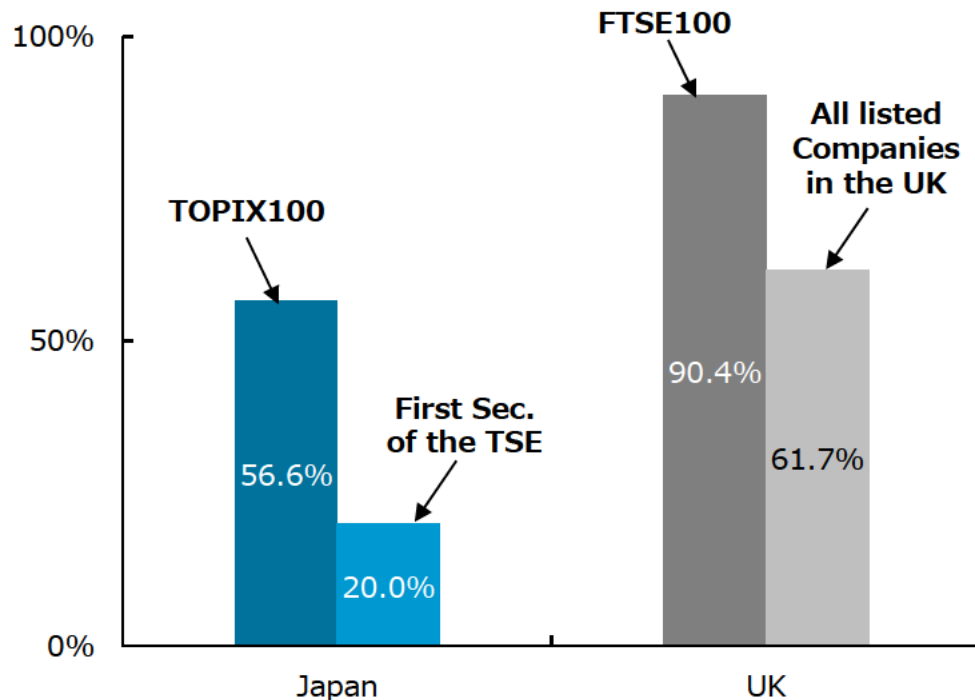


(Note) The results are based on a survey of 1,787 Japanese-based companies.  
(Source) Sumitomo Mitsui Trust Bank (October 2021).

# Composition of the top management team and authority delegation

- The guidelines state that it is effective to clarify the responsibilities and authority of each executive officer in the top management team led by the president/CEO, then delegate authority to them accordingly.
- It is important to make sure of the diversity of the top management team led by the president/CEO in order to create innovation, and their information including the diversity aspect should ideally be actively disclosed.

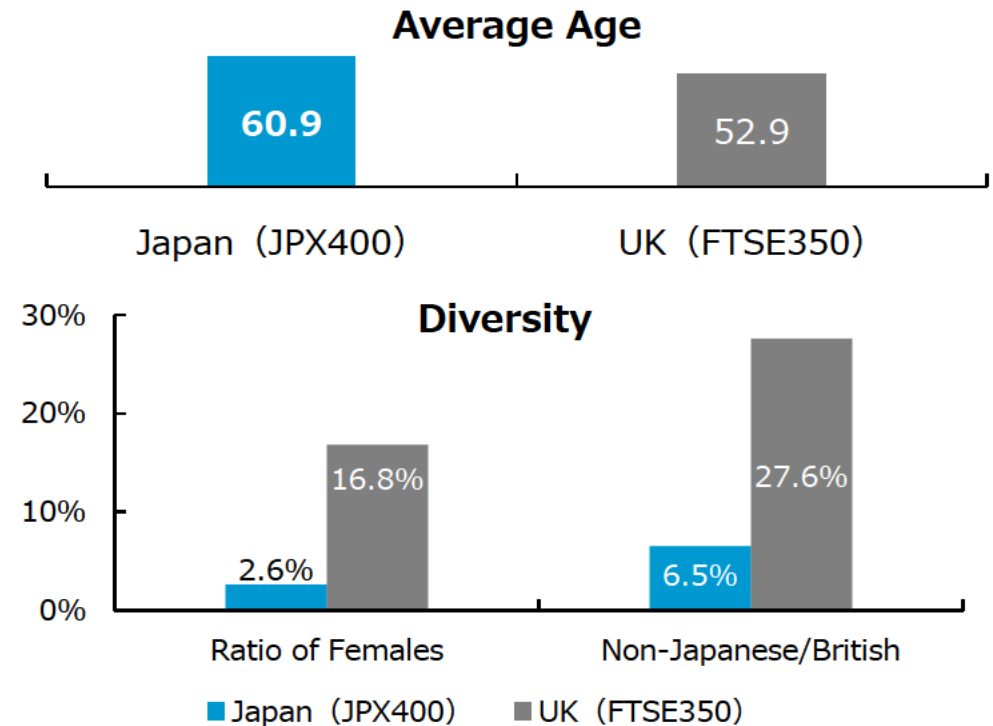
## Ratio of Companies Establishing CXOs



(Note) Aggregated data for 9 major CxOs excluding CEOs, and officers who concurrently serve as multiple CxOs are counted and aggregated for each CXO.

(Source) OSIRIS, Kubo et al.

## Comparison of top management team



(Note) Data corresponding to "Executives" was extracted, and "Non-Executive Directors" was excluded from the data, which was defined as the top management team and aggregated.

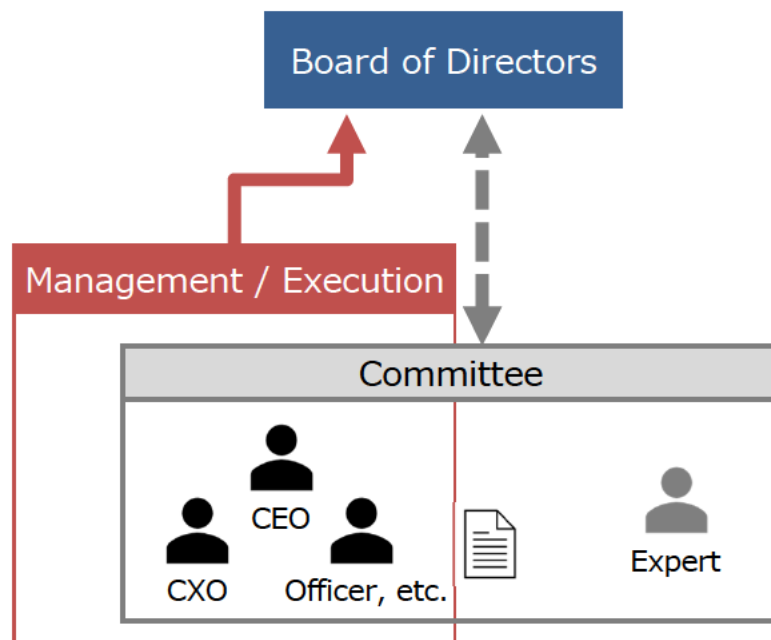
# Using committees to strengthen managerial and executive functions

- One possible option for strengthening the managerial and executive functions is as follows: **establish committees to consider and promote specific themes (like strategies, sustainability), based on the commitments of the president/CEO.**

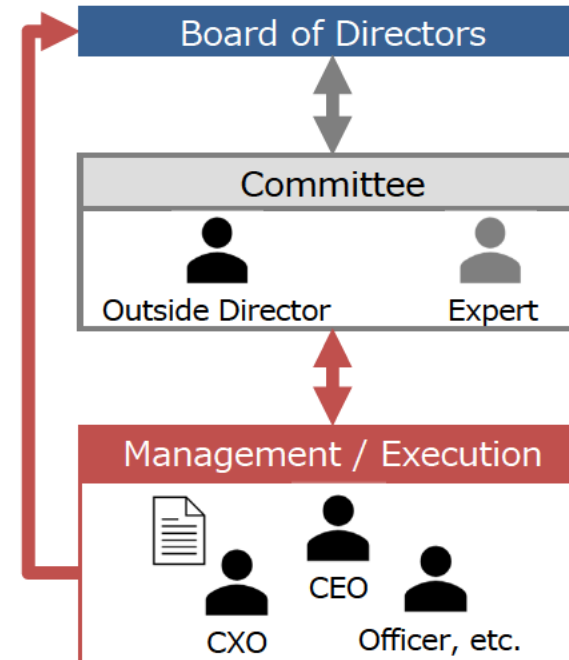
Note: There are also committees for the purpose of strengthening and complementing the functions of the board of directors.

- **If the purpose is to strengthen the managerial and execution functions, it is assumed that the committee members consist mainly of inside directors.**

## Strengthening Managerial and Executive Functions



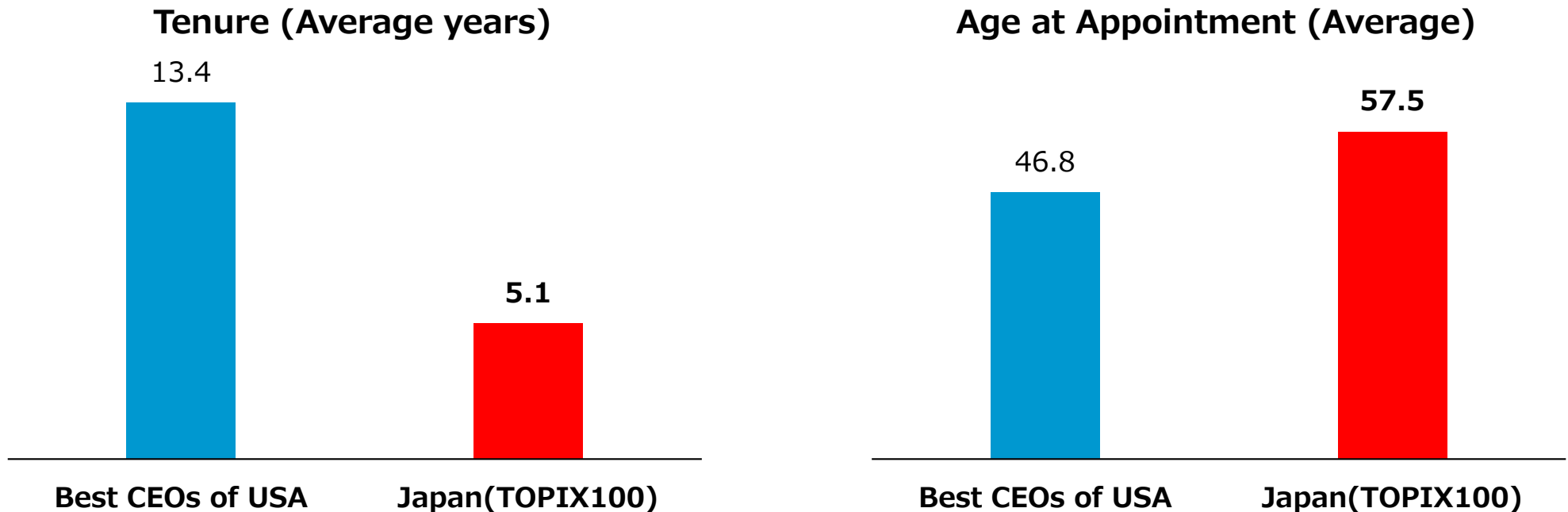
## Strengthening and Complementing the Functions of the Board of Directors



# Ensuring a period of time for pursuing the management strategy

- For the purpose of long-term corporate value creation, it is important to appoint younger candidates to positions and not replace them with a successor after a few years based on seniority.

## Internally Promoted CEO Tenure and Appointment Age



(Note) US: Average 36 of 49 CEOs selected by Harvard Business Review in the 2018 edition of "World's Best 100 CEOs" excluding founders and CEOs invited from outside.

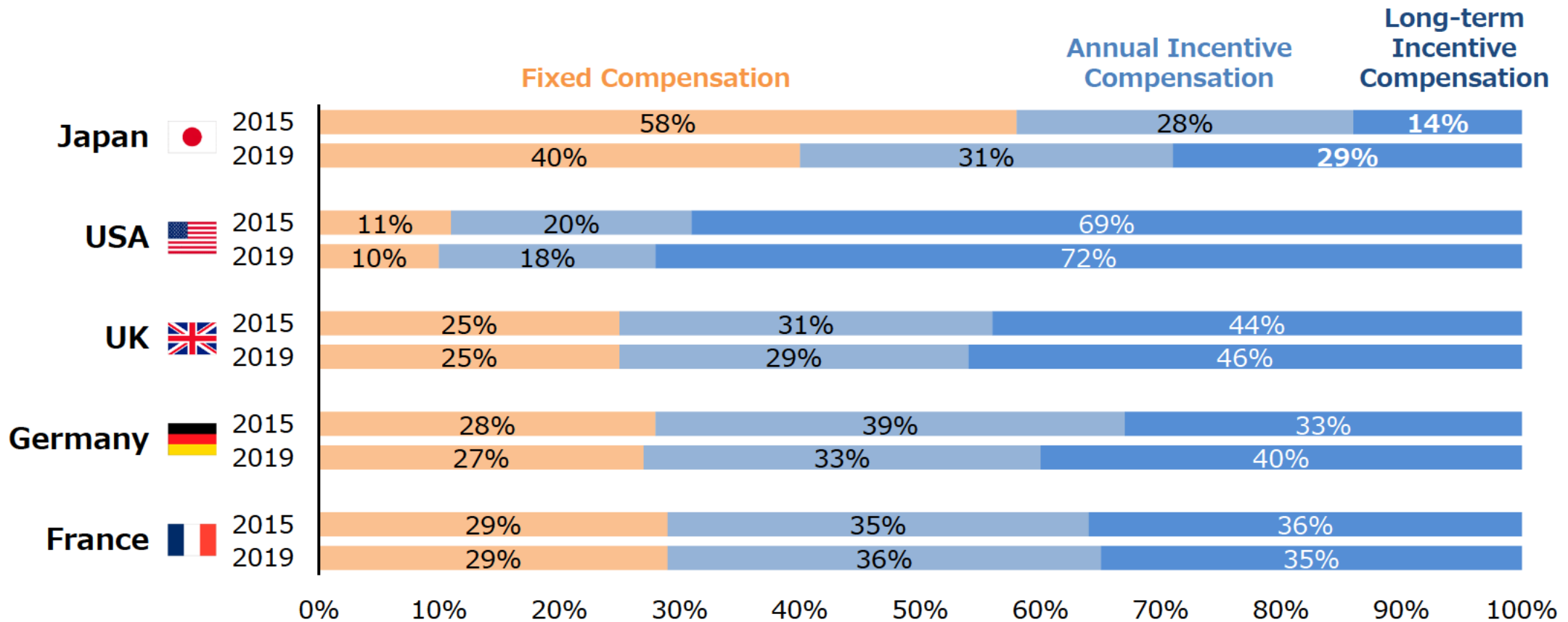
Japan: Average 95 of CEOs in TOPIX100 Companies excluding 5 founders.

(Source) NLI Research Institute

# Top Management's Compensation

- The guidelines state that making the proportion of long-term incentive compensation the same as the global level of around 40 to 50% is the best practice for the top management's compensation.

## Comparison of CEO Compensation Composition by Country



(Note) Targeting companies with sales of 1 trillion yen or more.

(Source) Willis Towers Watson (2020)



## **2. Corporate Value Creation**

# Overview of the Ito Review 3.0

[https://www.meti.go.jp/english/press/2022/0831\\_003.html](https://www.meti.go.jp/english/press/2022/0831_003.html)

- Amidst a rapidly changing business environment, the Ito Review 3.0 was formulated, **advocating the importance of corporate management centered on sustainability** as a means of increasing sustainable corporate value.
- In addition, "Guidance for Collaborative Value Creation 2.0" was formulated as a guide for companies, investors, and others to implement SX.
  - ⇒ Reinvigorate the "earning power" of Japanese companies through the implementation of SX.

## Ito Review 3.0 (Ito Review SX Edition) (2022)

- In a rapidly changing business environment (diversification of sustainability issues, increase in uncertainty in the global economy), addressing sustainability goes beyond being a risk that companies must deal with and is a fundamental element of business strategy
- It is important for various players (e.g., companies and investors) to implement SX by engaging in constructive dialogues on how long-term management should be and refining such management
- Formulated the Guidance for Collaborative Value Creation 2.0 (i.e., a framework for the management enhancement, effective information disclosure and constructive dialogues to achieve SX)

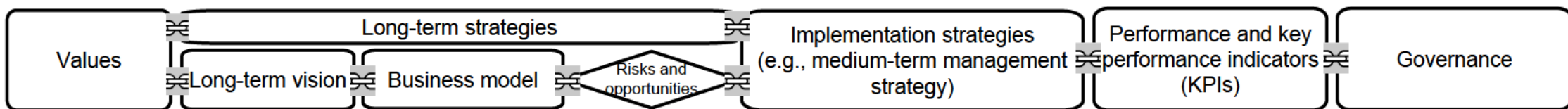
## Ito Review 2.0 (2017)

- For the purpose of reinvestment by companies, "intangible asset investment" is important, which forms the source of competitive advantage and innovation
- Need to provide a scenario to explain that intangible asset investments and ESG responses are "investments" necessary to enhance corporate value over the medium- to long-term
- Formulated the Guidance for Collaborative Value Creation as a "common language" for the content of dialogue between companies and investors

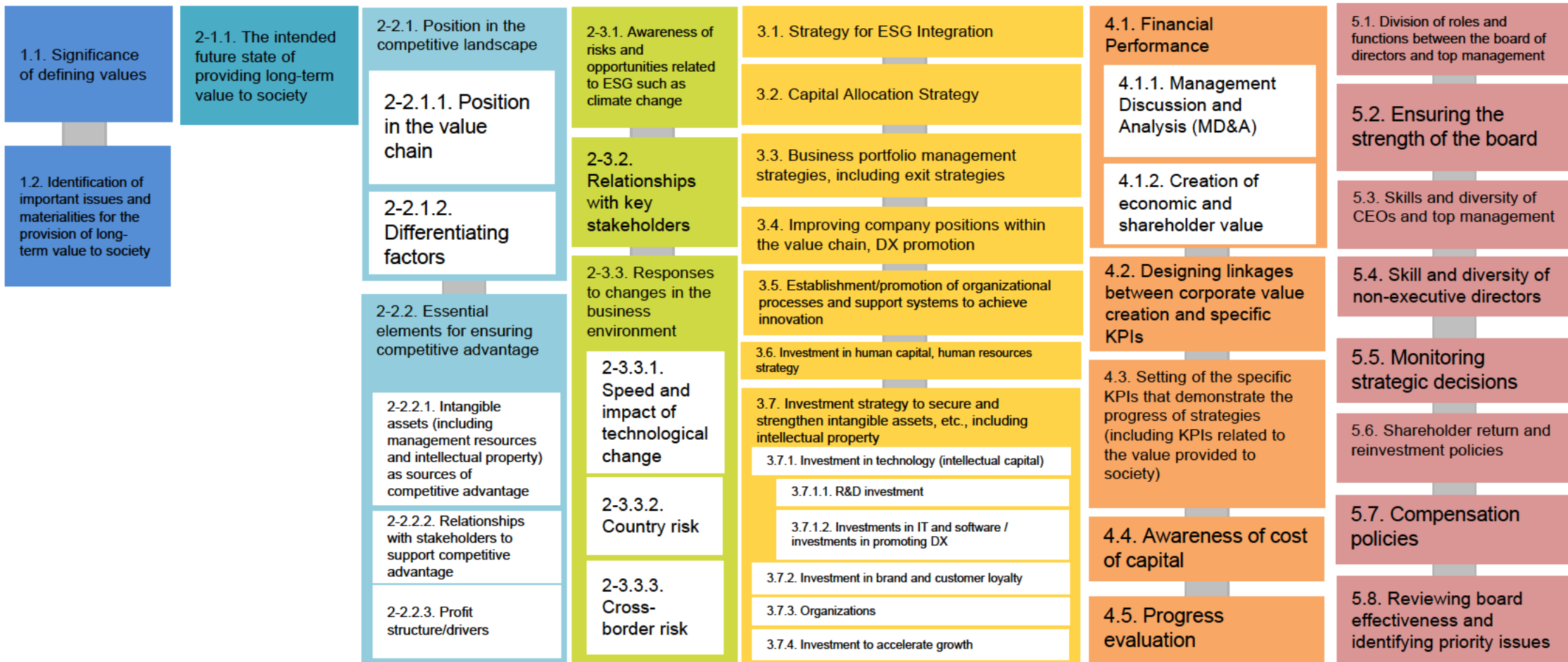
## Ito Review (2014)

- Awareness of the paradox of Japanese companies' sustained low profitability despite their ability to create innovations, and of investors' short-term orientation
- Reinvestment by companies for long-term innovation and medium- to long-term corporate value growth through investment from investors with a medium- to long-term perspective are important
- From the perspective of capital efficiency, it is important to achieve ROE that exceeds the cost of capital

# Overall diagram of the Guidance for Collaborative Value Creation 2.0



Look ahead to long-term social sustainability to synchronize it with corporate sustainability



## Substantive dialogue and engagement

Deepen dialogue and engagement with investors and refine the value-creation scenario under the division of roles and commitment of the board and top management

6.1. Principles of substantive dialogue, etc.

6.2. Content of substantive dialogue, etc.

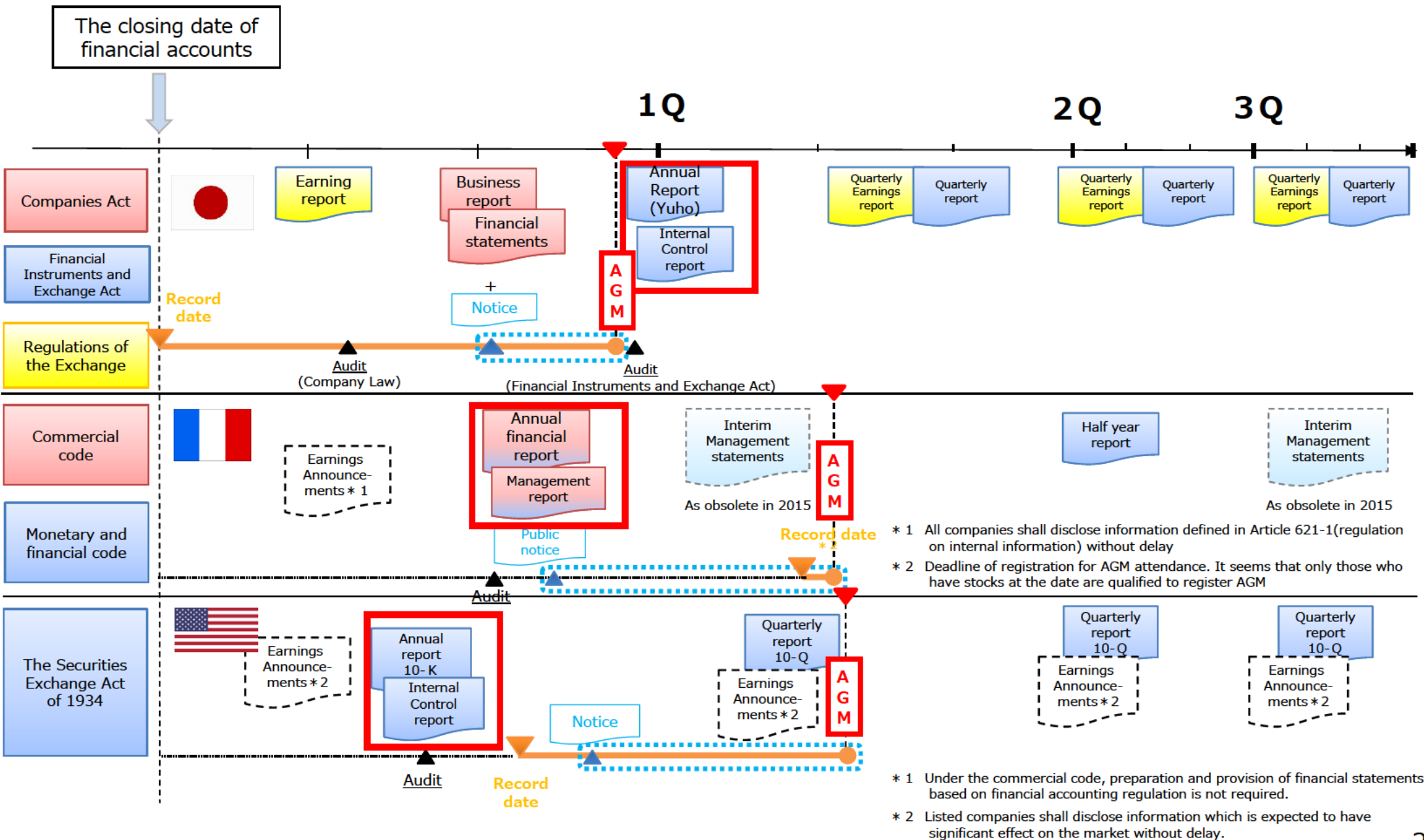
6.3. Methods of substantive dialogue, etc.

6.4. Action after substantive dialogue, etc.

### **3. Disclosure timing in Japan of**

- (1) Company Securities report (Yuho) and
- (2) Sustainability-related information

# The comparison of the annual disclosure schedules of listed companies in Japan, France and the US.



# The comparison of the gap between the timing of disclosure of annual report and the timing of disclosure of report including sustainability information

	Japanese Companies	U.S. Companies	European Companies
Average GAP (Top 30 in Sales)	<b>2.9months</b>	<b>4.0months</b>	<b>0.03months</b>

\* Gap between the timing of disclosure of annual reports and the timing of disclosure of reports including sustainability information for the five top revenue-generating companies in Japan, the U.S., and Europe.

(Source) Survey commissioned by the METI

# **4. Human Capital Management**

# ITO Report for Human Capital Management

- The Ministry of Economy, Trade and Industry has organized two study groups to encourage human capital management in Japanese companies from 2020 to 2022, chaired by Kunio Ito, a professor emeritus at Hitotsubashi University. The culmination of these discussions is the "Ito Report for Human Capital Management" .
- The first edition of the Ito Report on Human Capital Management, which included these perspectives, was reflected in the 2021 revision of the Corporate Governance Code, which is a set of rules for listed companies that requires their investment in and disclosure of human capital initiatives. The "Ito Report on Human Capital Management 2.0" , published in 2022, has been read by many Japanese corporate executives and managers in charge of human capital management as a guide to concrete actions to be taken.



# Human Capital Management Consortium

- Human Capital Management Consortium was established with the support of 320 Japanese corporations from the perspective of promoting both the “implementation of human capital strategies linked to business strategies” and the “disclosure of human capital initiatives”.

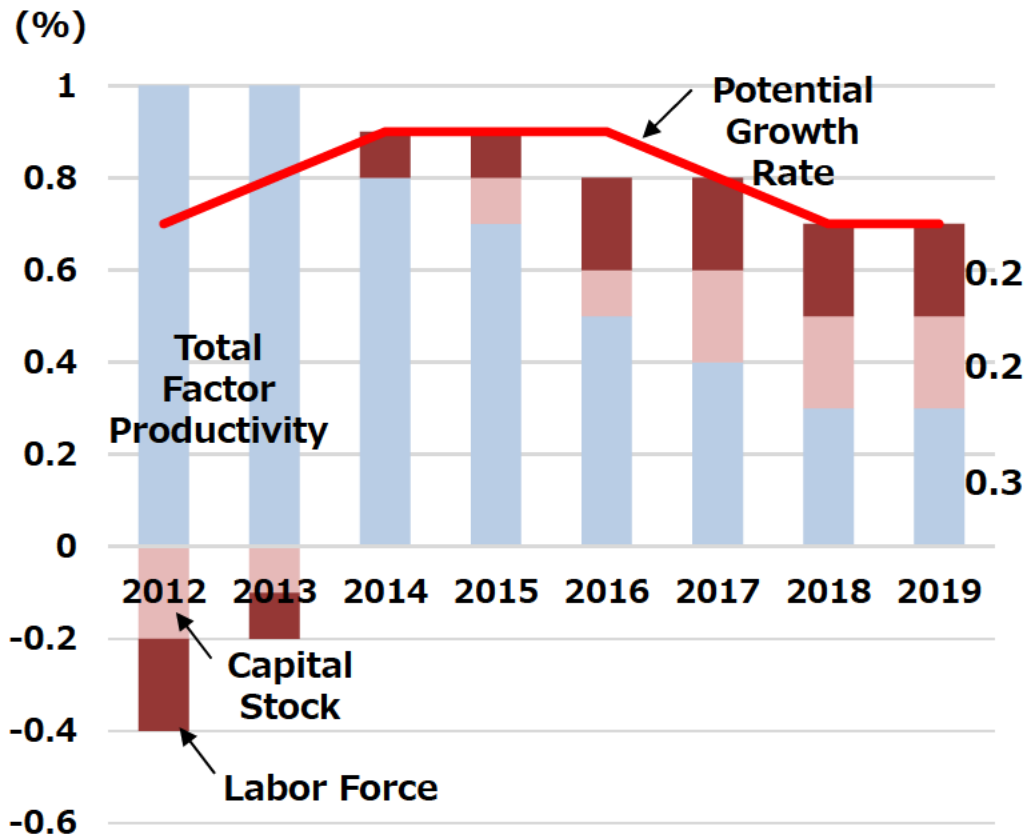


# Reference

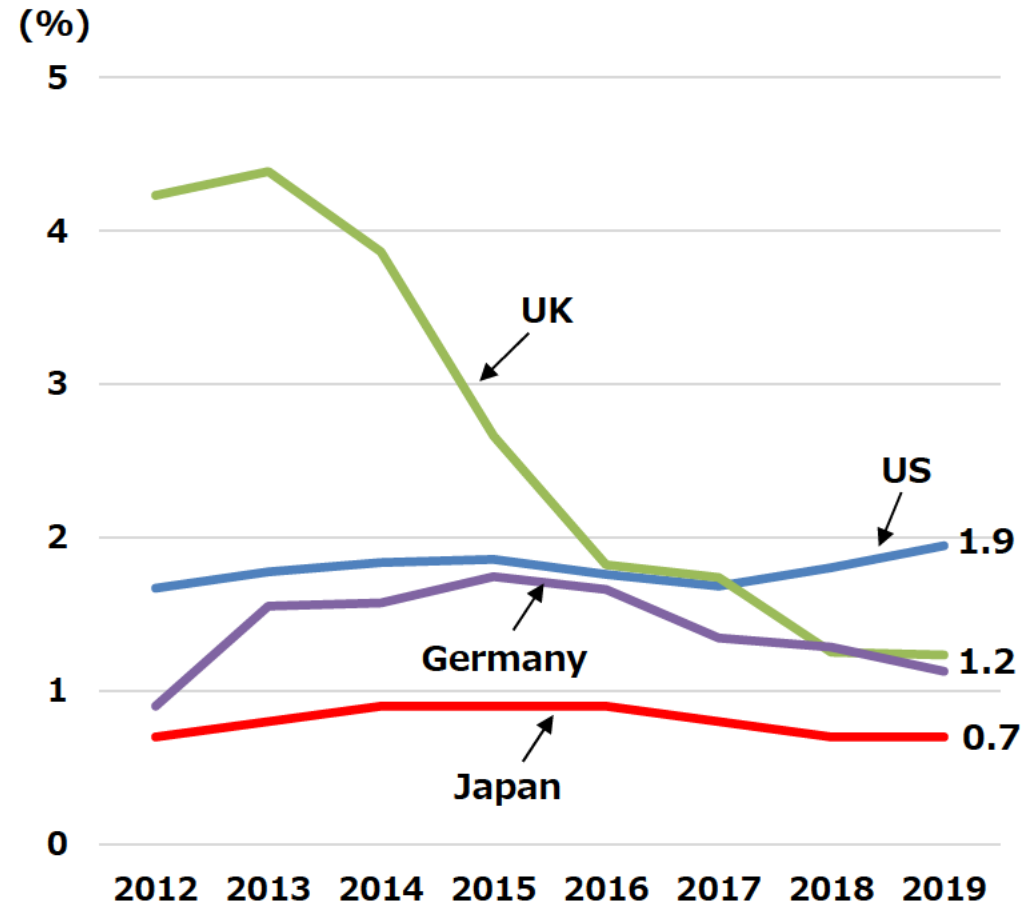
# Stagnant Economic Growth

- Since the 1990s, Japan's potential GDP growth rate has consistently been lower than other developed countries.

**Japan's potential GDP growth (2012-2019, by factor)**



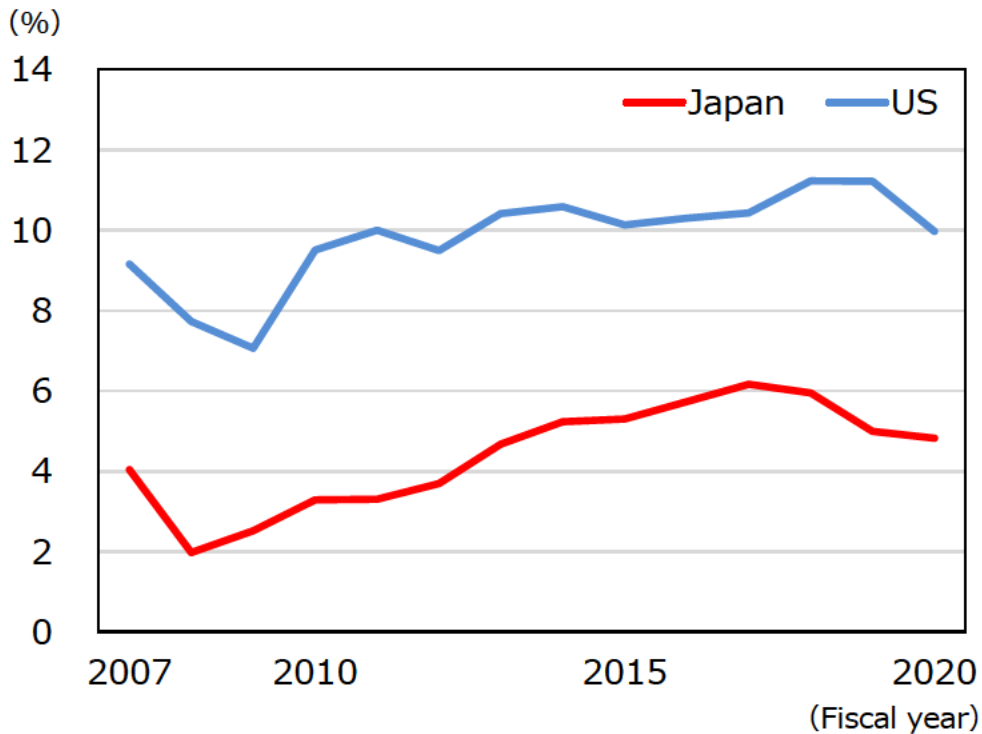
**International Comparison of Potential Growth Rate (2012-2019)**



# Japanese companies' low profitability

- For nearly 30 years, Japanese companies have had lower profitability than those of other countries. The growth of corporate value represented in stock price is the worst among Western and Asian countries.

## Comparison of ROS (Return on Sales) between Japan and the U.S.



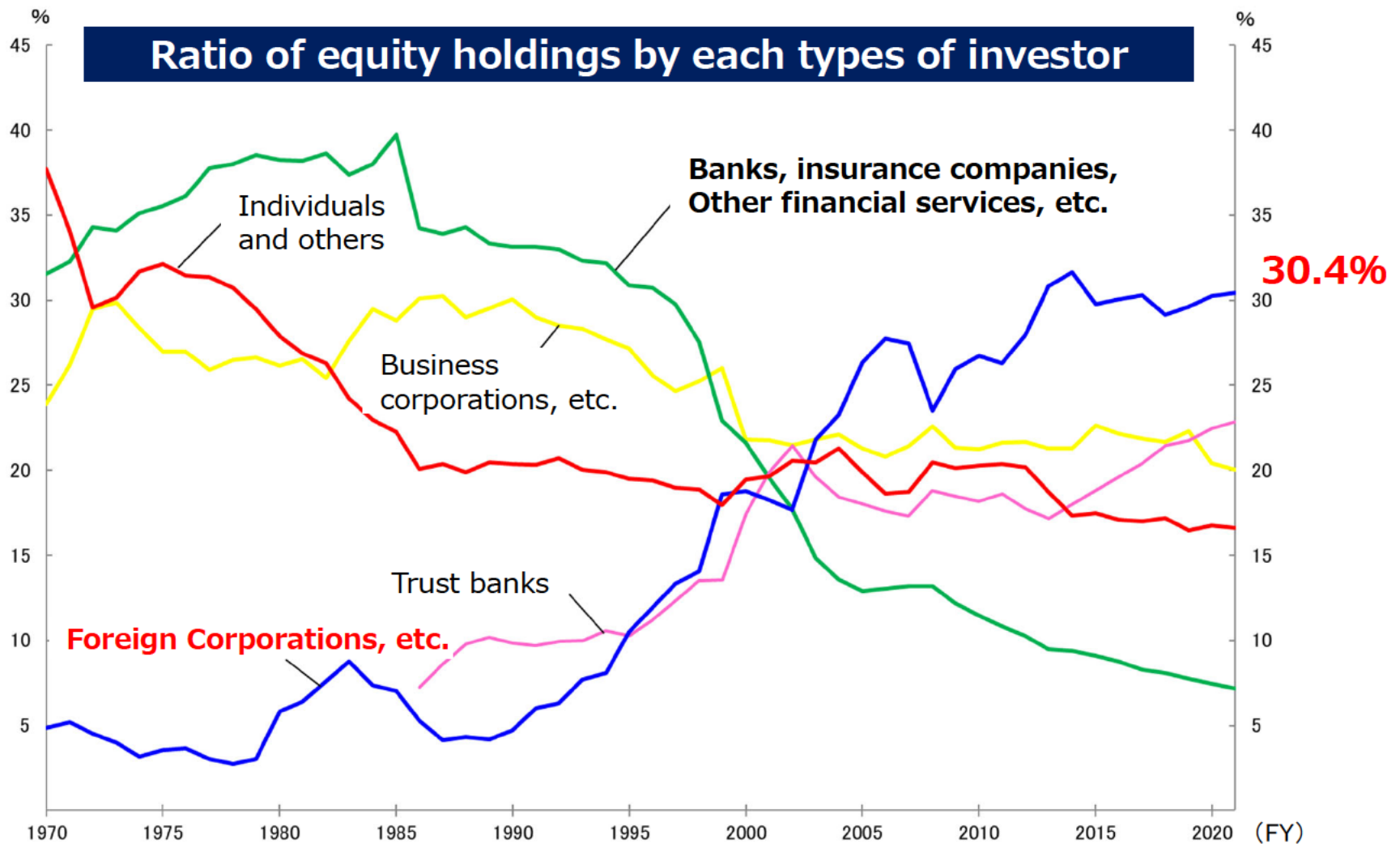
(Note) TOPIX500 for Japan and S&P500 for the U.S.  
 (Source) Bloomberg.

## Long-term trends in equity indices (1990 vs. 2022)

	1990	2022	Ratio
Nikkei 225 (Japan)	23,849	26,848	x1.1
Dow Jones	2,634	32,979	x13
FT100 (UK)	2,143	7,545	x4
DAX (DE)	1,398	14,098	x10
Hang Seng	3,025	21,089	x7
BSE Sensex	1,048	57,061	x54
Shanghai	128	3,047	x24
Jakarta Composite	418	7,229	x17
SET (TH)	613	1,667	x3

(Note) The numbers are from late December in 1990 and late April in 2022.  
 (Source) Investing.com.

# Trend of equity holding ratios



(Note)

**Foreign corporations, etc.:** Corporations established under the laws of a foreign country, foreign governments, local governments, organizations without juridical personality, and individuals with non-Japanese nationality, regardless of whether they reside inside or outside Japan.

**Business corporations, etc.:** All domestic corporations with legal personality other than financial institutions and securities companies.

**Individuals and others:** Individuals of Japanese nationality, regardless of whether they reside in or outside Japan, and unincorporated organizations in Japan.

(Source) TSE, et al (July 2022)

# Characteristics of Japanese corporate governance

## Rules on the Companies Act

- Traditionally the “management model” is used in a traditional company with an Audit & Supervisory Board.
- After revisions of the Companies Act, companies can choose their governance model from three options.

## Corporate Governance Reforms

- Since 2013, the government has led corporate governance reforms as a part of its “Growth Strategy”.
- The Corporate Governance Code formulated by the Tokyo Stock Exchange establishes the comply-or-explain based rule.



As a result, Japanese corporate governance has undergone rapid change over the past several years.

# History of corporate governance reforms (1/2)

Schedule

Main points

Strategy for the Revitalization of Japan (2013)

Feb. 2013  
Cabinet decision

- It includes the proposal of legislation of the Companies Act to promote the introduction of independent directors and the introduction of Japan's Stewardship Code.

Stewardship Code established

Feb. 2014

- It includes the "stewardship responsibility" provision to encourage institutional investors/asset owners to disclose their acceptance statements and responsibility fulfillment policies.

"Ito Report"

Aug. 2014

- It presented a way of sustainable corporate value creation through "dialogue and engagement" between companies and investors.

Companies Act amended

May. 2015  
Enforced

- The Companies Act was amended to establish provisions regarding stricter requirements for independent directors, etc.

Corporate Governance Code established

June. 2015

- The major principles were established to contribute to make corporate governance effective. **The appointment of two independent directors was enforced as the general rule.**

Corporate Governance System Guidelines

Mar. 2017

- It shows best practices to promote the utilization of **independent directors and the Nominating and Compensation Committee.**

Japan's Stewardship Code revised

May. 2017

- It promotes in-depth "constructive dialogue" between companies and institutional investors and the disclosure of voting results.

# History of corporate governance reforms (2/2)

Schedule

Main points

Corporate Governance Code revised

July. 2018

- It includes **the clarification of the criteria for CEO selection and dismissal**, and **the establishment in principle of a Nominating and Compensation Committee.**

CGS Guidelines revised

Sep. 2018

- In the light of the revised code, it presented best practices for the development and operation of succession plans for presidents and CEOs.

Group Guidelines established

June. 2019

- In order to ensure the effectiveness of group governance, it presented **best practices concerning governance and internal controls of listed subsidiaries.**

Companies Act amended

Dec. 2019  
Enforced

- It was amended to make it mandatory for companies **to have directors**, and to revise principles regarding directors' compensation etc.

Stewardship Code re-revised

Mar. 2020

- Sustainability was added to the "stewardship responsibilities" section, and asset owner engagement was encouraged, in order to enhance value over the mid- to long term.

Practical Guidelines for Business Transformations

July. 2020

- It presented best practices for the review of business portfolios, such as practical ideas for smoothly executing business carve-outs.

Practical Guidelines for Independent Directors

July. 2020

- It presented **best practices for the roles and mindsets of directors and their specific actions.**

Corporate Governance Code re-revised

June. 2021

- It established the principles of **the appointment of 1/3 of independent directors** in the Prime market and sustainability disclosures. It also includes business portfolio reviews, etc.

CGS Guidelines re-revised

July. 2022

- Because entrepreneurship and animal spirits were demonstrated in sound ways for enhancing the "earning power" of Japanese companies, it presented **best practices for both executive and monitoring functions.**



# Re-revision of the Corporate Governance Code (June 2021)

## Main points of re-revision

### Effectiveness of the Board

- Companies should appoint at least one-third of their directors as independent directors.\*
- The board should disclose the combination of skills that each director possesses in an appropriate form such as a "skills matrix".

### Nominating and Remuneration Committee

- Companies should basically have a majority of the members of each committee be independent directors.\*

### Business Portfolio

- The board should effectively supervise the implementation of business portfolio strategies.
- Companies should clearly present the basic policy on the business portfolio.

### Listed Subsidiary

- Companies that have a controlling shareholder should either appoint the majority of directors as independent directors or establish a special committee composed of independent persons.\*

### Diversity

- Companies should present their policies and disclose voluntary and measurable goals for ensuring diversity in promotion of core human resources, such as women, foreign nationals and midcareer hires.

### Sustainability

- The board should develop a basic policy for the company's sustainability initiatives and appropriately disclose it.
- Companies should analyze the impact of climate change-related risks and enhance the quality and quantity of disclosure based on the TCFD recommendations or an equivalent disclosure framework.

\*Principles which apply only to listed companies on the Prime market of the TSE.

# (Reference) The concept of “growth-oriented governance”

- The purpose of “growth-oriented governance” is primarily to stimulate healthy corporate entrepreneurship by promoting the timely and decisive decision-making of Japanese companies.

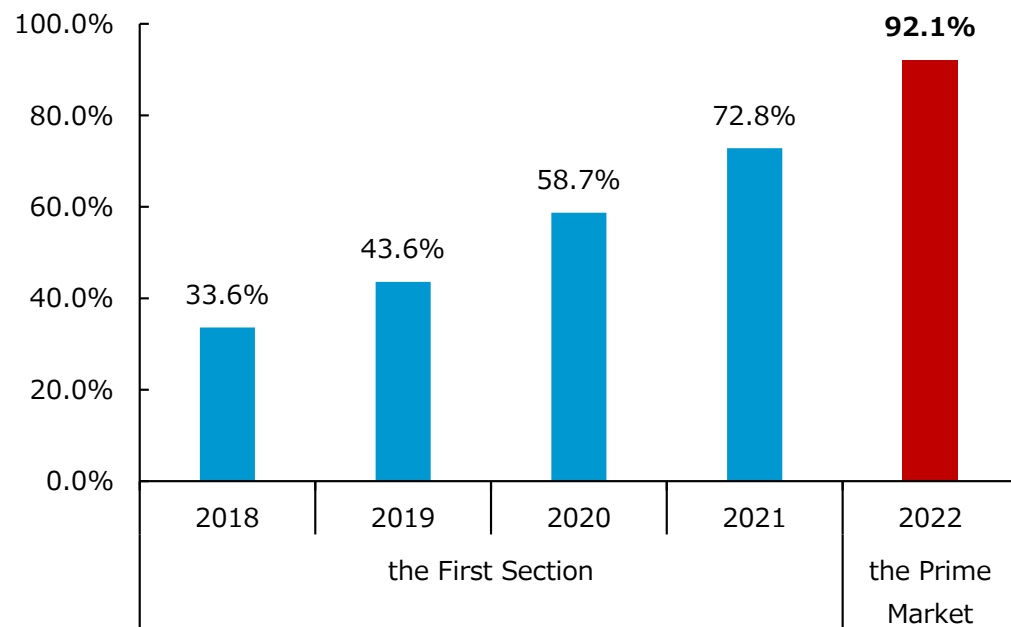
## The Preamble of “Japan’s Corporate Governance Code [Final Proposal]” Section. 7

7. It is important that companies operate themselves with the full recognition of responsibilities to a range of stakeholders, starting with fiduciary responsibility to shareholders who have entrusted the management. The Code seeks **“growth-oriented governance” by promoting timely and decisive decision-making based upon transparent and fair decision-making through the fulfillment of companies’ accountability in relation to responsibilities to shareholders and stakeholders.** The Code does not place excessive emphasis on avoiding and limiting risk or the prevention of corporate scandals. Rather, **its primary purpose is to stimulate healthy corporate entrepreneurship, support sustainable corporate growth and increase corporate value over the mid- to long-term.**

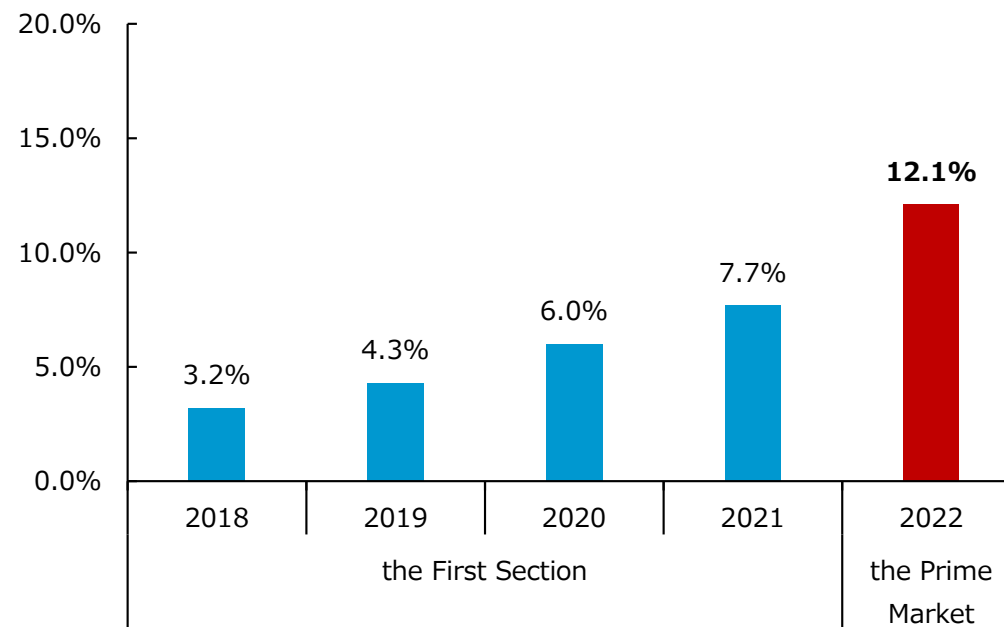
# Appointment of outside directors

- Since the establishment of the Corporate Governance Code, **more and more outside directors have steadily been appointed.**
- The new Corporate Governance Code has a principle requiring companies listed on the Prime Market **to appoint at least one-third of their directors as outside directors.**

Ratio of listed companies appointing at least **one-third** of outside directors



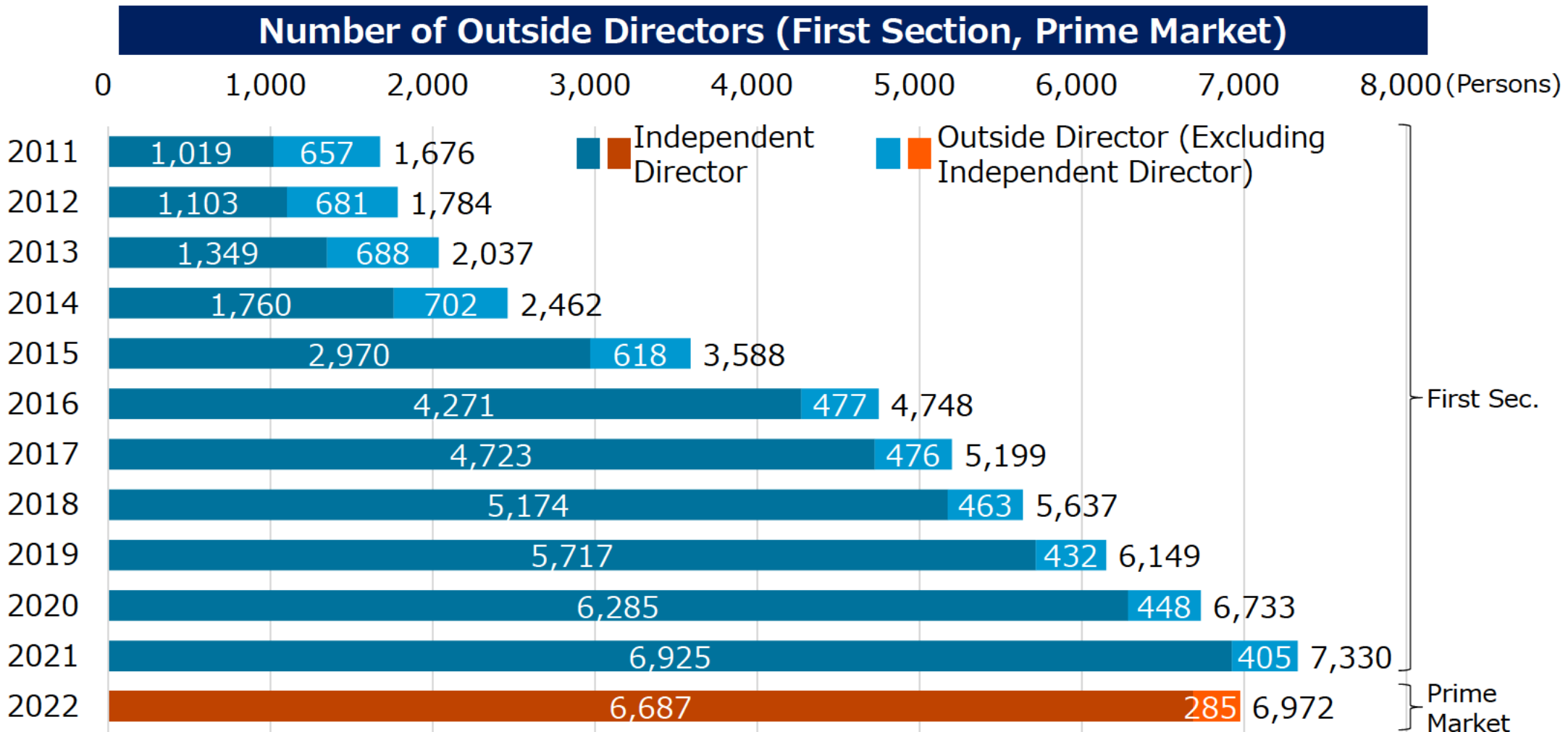
Ratio of listed companies appointing a **majority** of outside directors



(Source) Tokyo Stock Exchange (August 2022).

# Increasing the number of outside directors

- The number of outside directors in companies listed on the First Section / Prime Market of TSE has more than quadrupled in a decade.
- **As the number of outside directors increases, it becomes more necessary to improve the quality of outside directors.**

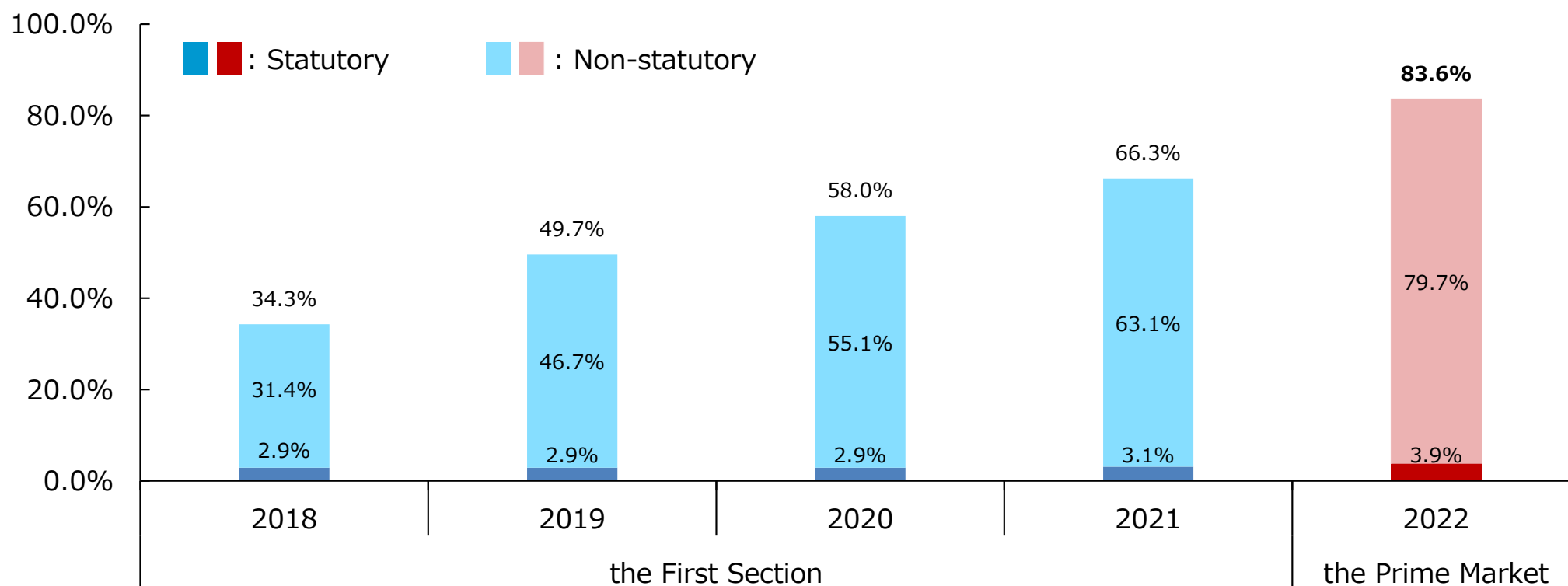


(Source) Japan Association of Corporate Directors (August 2021), EoL (July 2022).

# Establishment of nominating committee

- Non-statutory nominating committees are actively utilized.
- In 2022, more than 80% of companies listed on the Prime Market of the TSE (Tokyo Stock Exchange) have established nominating committees (Statutory / Non-statutory).

## Ratio of Establishing Nominating Committees (First Section, Prime Market)



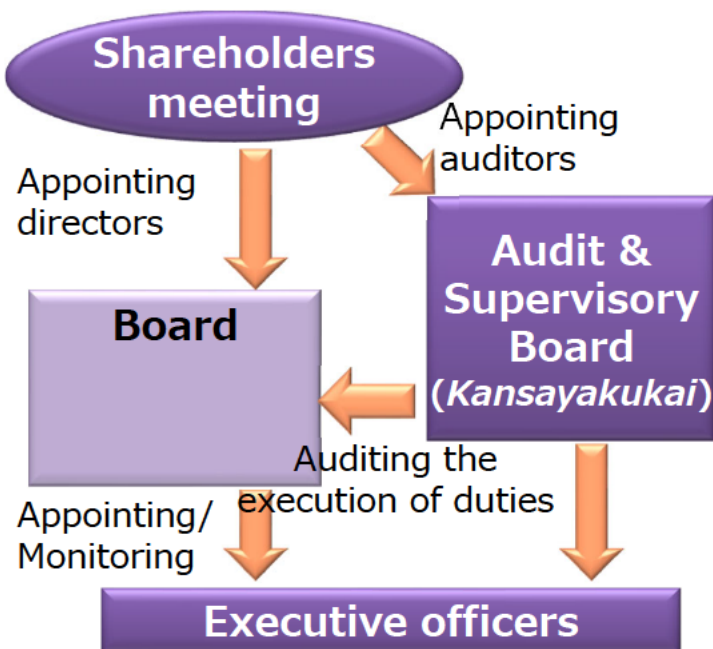
(Note) Targeting companies listed on the first section of the TSE (2017~2021), the Prime Market of TSE (2022).  
 (Source) TSE (August 2022).

# (Reference) Three forms of corporate organization

## Company with Auditors

*Traditional model*

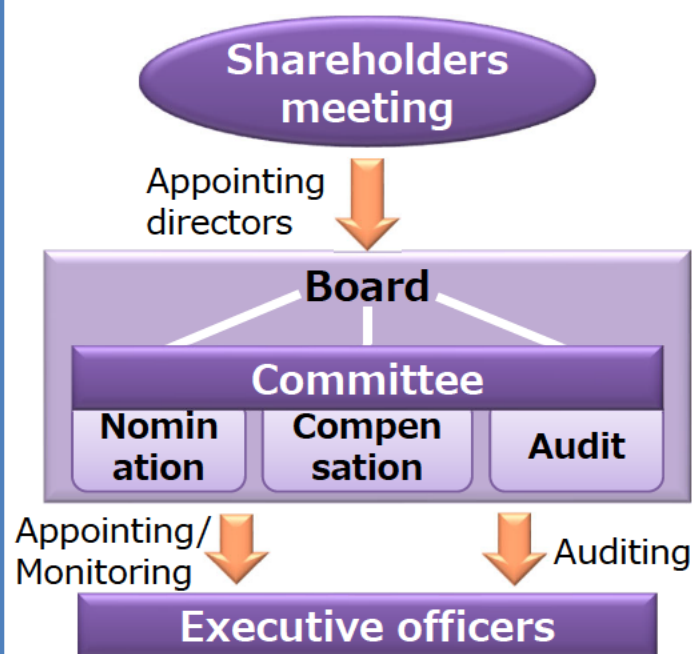
- Essential decisions on execution cannot be delegated to representative directors.
- Audit & Supervisory Board (*Kansayakukai*) has a majority of outside auditors.



## Company with Nominating Committee, etc.

*Available since 2003*

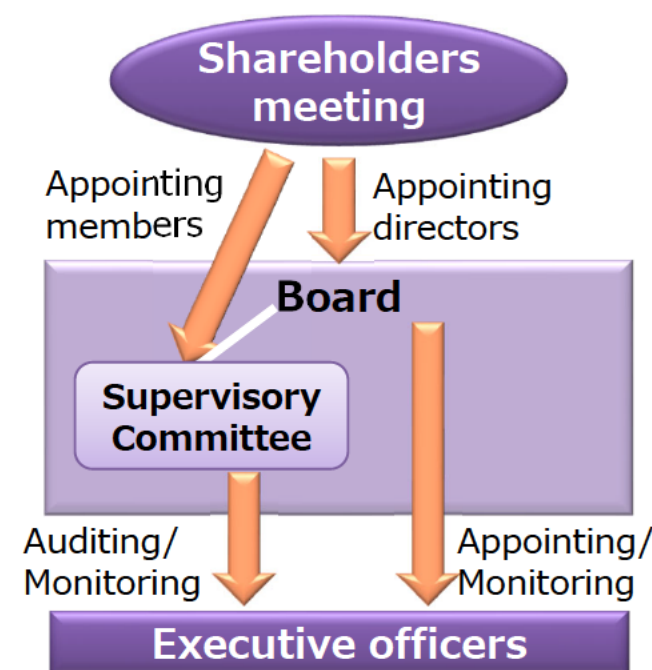
- Basic management policies are mandatory for resolution by the board of directors.
- Each committee has a majority of outside directors.



## Company with Audit and Supervisory Committee

*Available since 2015*

- Each committee has a majority of outside directors.



Nominating / Compensation Committee (statutory / non-statutory) are typically utilized in these forms.