



Corporate Governance Overview 2016

KPMG in Japan

September 2016

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On the Publication of Corporate Governance Overview 2016

Since 2013, measures to strengthen corporate governance have been introduced in rapid succession, including the debate on revisions to Japan's Companies Act and establishment of Japan's Stewardship Code and Corporate Governance Code. Indeed, 2015 was the year of corporate governance reform in Japan.

This report focuses on the changes that Japanese companies have faced as a result of this year's corporate governance reform. Based on this, the report also examines the current issues for corporate governance and the direction going forward, including the true meaning of effective governance, and how this leads to improvements in corporate value.

Approaches to corporate governance differ depending on the company. Japanese companies now have been given guidelines for corporate governance to some extent, but they would do well not to respond passively. Rather, it would be advantageous for them to see this as a good opportunity to be proactive.

In the second year of the Corporate Governance Code, there has been some progress on the "formality" side of corporate governance reform. The key issue is whether or not this can translate into substantial reform, including improvement in board operations and the talent of board members. It is also important that companies build collaborative relationships with a sense of tension through constructive dialogue with institutional investors and create positive cycles to raise their own corporate value.

This report has been written by experts in a range of fields related to corporate governance at KPMG Japan. We hope that the analysis and insights it contains provide motivation for future initiatives by Japanese companies working to raise corporate value.

September 2016

CEO of KPMG in Japan
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Outline

First, we will look at the role of corporate governance reform in Japan ("I. Corporate governance improves corporate value"). As illustrated by the term "growth-oriented governance," Japan's corporate governance reforms are aimed at raising companies' sustainable growth and medium- to long-term corporate value. To achieve this objective, it is important to change the awareness of institutional investors, including asset owners, and the retail investors who are the end investors, and hold constructive dialogue with companies. As a result, company returns can be restored to households via the investment chain. Moreover, after the establishment of Japan's Stewardship Code and Corporate Governance Code, companies experienced various changes. On the formality side of reforms, dialogue with investors became more frequent, independent outside directors were appointed, more companies adopted a Company with Audit and Supervisory Committee system, and more companies set up optional advisory committees on nomination and remuneration. (See "II. What changed as a result of the double codes?"). However, from the investors' perspective, the perception that generating returns in excess of cost of capital is essential in improving corporate value had not sunk in enough in companies. There are cases in which it is not clear how initiatives to change

the formality side of corporate governance actually lead to enhanced corporate value. Accordingly, this report discusses the direction of corporate governance, moving from formality to more substantial reform that encompasses board operations and the talent of board members ("III. Approach to corporate governance system"). Companies think about corporate value differently, as do investors, and other stakeholders also have different views. As such, we examine the current issues and the future directions for the objectives of and perspectives on dialogue between companies and investors, as well as disclosure, the very foundation for constructive dialogue. This discussion focuses on differences in the perception of corporate value by companies and investors ("IV. Dialogue with investors and approaches to corporate disclosure"). Debate over establishing an environment conducive to dialogue, including corporate information disclosure and the shareholder meeting process, is underway, with the aim of promoting dialogue between companies and investors. This report also introduces these trends ("V. Trends in debate over providing environment for dialogue"). By following these stories, this report is intended to provide an overview of the corporate governance reform currently underway, as well as lay out the current issues facing corporate governance, the initiatives taken by companies, and the approaches to relationships with investors, in particular.

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1.

Corporate governance leads to increased corporate value

POINT

- » Since 2013, debates over revisions to the Companies Act (the revised Companies Act was promulgated in 2014) have been underway and Japan's Stewardship Code and Corporate Governance Code have been established. These efforts were aimed at pulling out of the negative cycle characterized by prolonged economic malaise and restoring the corporate sector's ability to generate revenue.
- » The overall optimization of the investment chain, in which the returns that investors receive from corporate investments are returned to households, creates a virtuous cycle that raises corporate value.
- » The key to optimizing the investment chain is for investors with the responsibility for stewardship and companies responding on their own initiative to comply with the Corporate Governance Code to engage in constructive dialogue, and thereby achieve a shift to medium- to long-term investments on the part of investors and gains in corporate value at the same time.



1 Corporate governance reform as a growth strategy

Japan needs to end the protracted economic stagnation suffered since the bubble burst in the early 1990s, pull out of the negative cycle resulting in the “lost 20 years,” and restore earning capacity (revenue-generating capacity) to the Japanese economy as a whole. This requires companies at the core of the economy to boost their productivity and profitability in the medium to long term and survive global competition. To achieve this, companies will have to implement appropriate corporate governance disciplines that will encourage risk-taking by management and raise sustainable growth and medium- to long-term corporate value.

2014 revised Companies Act and Japan’s Stewardship Code and Corporate Governance Code

Based on the 2013 growth strategy (the Japan Revitalization Strategy), the government released Japan’s Stewardship Code. This code lays out effective principles that help institutional investors fulfill their stewardship responsibilities, which is defined as the responsibility to increase the medium- to long-term investment returns of clients and beneficiaries by encouraging higher corporate value and sustainable growth in companies through constructive engagement. These principles, which were modeled on the UK Stewardship Code and based on Japan’s current state of affairs, were devised by the Financial Service Agency’s Council of Experts and released as Japan’s Stewardship Code.

This code is unique primarily because it introduces the concept of “comply or explain.” The 2014 revised Companies Act, which established the Company with Audit and Supervisory Committee system and was promulgated in June 2014, partially built this concept into its regulation requiring

that companies provide an explanation if they do not appoint external directors.

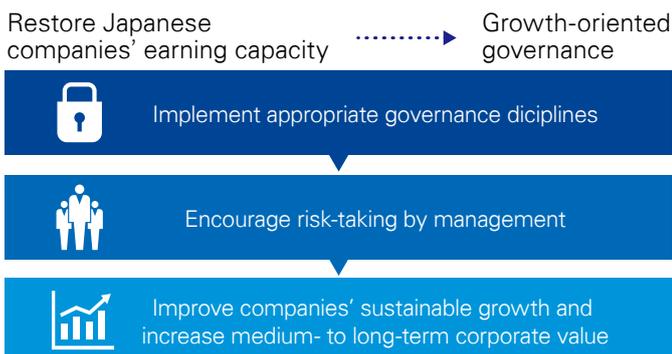
The growth strategy, revised the following year, designated the reinforcement of corporate governance as the most important issue. A draft of a corporate governance code was formulated by a committee of experts headed jointly by the Tokyo Stock Exchange (TSE) and the Financial Services Agency (FSA) in order to encourage self-initiative in acting to promote sustainable corporate growth and raise medium- to long-term corporate value. In response, the TSE revised the related Listing Regulations, and the Corporate Governance Code was established and went into effect in June 2015. As with Japan’s Stewardship Code, the Corporate Governance Code introduced the concept of comply or explain. However, it differed from the Stewardship Code in that listed companies that infringed upon the “comply or explain” requirement of the Corporate Governance Code would also be violating the Listing Regulations.

Slump in the stock market and the market’s short-termism

As pointed out by the so-called Ito Review,* the prolonged low profitability of Japanese companies impeded the creation of corporate value and, as a result, the Japanese stock market was in a slump for a long time. The “efficient” action for investors to take in this kind of market is to maximize capital gains with short-term trading and engage in passive investing, such as index benchmarking (a method of investing that aims to achieve results by aligning investments with benchmarks). Such behavior has encouraged short-termism in the market.

* Ministry of Economy, Trade and Industry’s Final Report of the Ito Review “Competitiveness and Incentives for Sustainable Growth: Building Favorable Relationships between Companies and Investors” Project (August 2014)

■ Figure 1. Objectives of corporate governance reforms



■ Figure 2. Revised 2014 Companies Act and Code



2 — Overall optimization of investment chain

The market's short-termism hinders engagement with a medium- to long-term perspective by institutional investors.

The primary message of the Ito Review was on the importance of management reform focused on capital efficiency, overall optimization of the investment chain, and encouragement of dialogue between companies and investors.

Investment chain

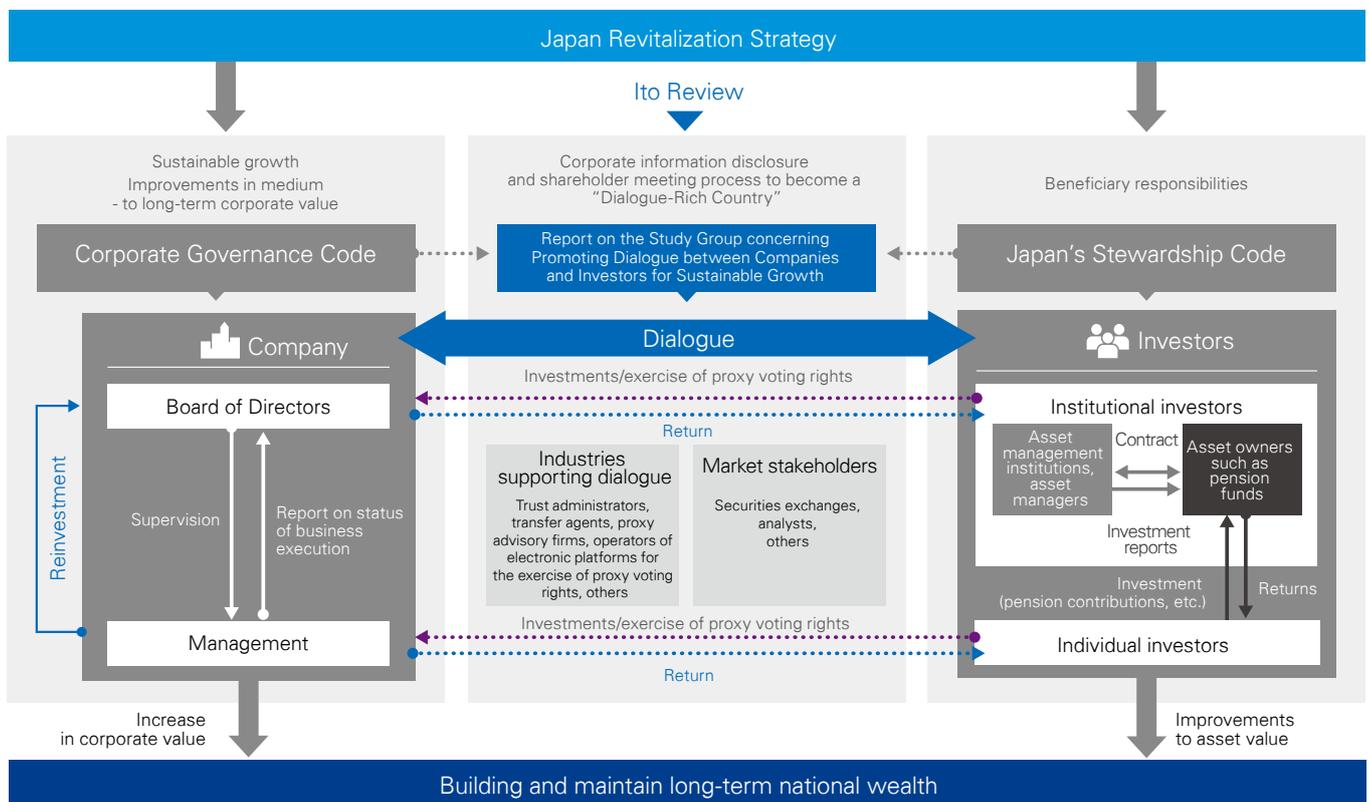
The investment chain is a flow in which the investor creates medium- to long-term value through dialogue with a company and the returns thus generated are ultimately returned to households, thereby building and maintaining national wealth.

Various stakeholders are involved at different points of this chain, linking investors to companies. Figure 3 uses the example of the citizen as a pension beneficiary and

individual investors as the end investor. In this case, asset owners, including the pension funds, insurance companies and others who lend money, and the asset managers who are entrusted with managing this money and investing in companies play a role as institutional investors in the chain between the end investor and the company. There is also an entire industry devoted to supporting this dialogue, including custodians, transfer agents, proxy advisory firms and operators of electronic proxy voting platforms.

To ensure that the returns from value creation are ultimately returned to households and national wealth is built and maintained, it is essential that those involved in this chain build a foundation that enables constructive dialogue to take place and encourages institutional investors to shift to investments based on a medium- to long-term perspective, and it is also vital that companies cooperate with institutional investors and work to improve sustainable growth. This, in

■ Figure 3. Overview of Corporate Governance Reform



turn, requires that institutional investors fulfill their stewardship responsibilities based on Japan's Stewardship Code and that companies address their own governance issues in line with the Corporate Governance Code. When companies and institutional investors take collaborative action to raise sustainable growth and improve corporate value in the medium- to long-term, the investment chain is optimized, and as a result, the medium- to long-term investment returns of beneficiaries (the end investor) are expanded, thus building and maintaining national wealth.

Dialogue between companies and investors as used here includes diverse forms of communication, such as the ongoing and direct communication that takes place at the various touchpoints which are associated with the information disclosure of a company. In order to improve the quality of this dialogue, the perceptions and behavior of the organizations and people supporting the dialogue will also have to change. The Ito Review was published after Japan's Stewardship Code was established, and was followed by the release of the Corporate Governance Code. However, in order that these two codes function efficiently together, the Ito Review recommends a virtuous cycle of value creation in which the optimization of the investment chain achieved by applying these codes leads to the building and maintaining of national wealth. The Review provides an overview of the direction of corporate governance reforms in Japan.

II.

What changed as a result of the double codes?

POINT

- » Since the establishment of Japan's Stewardship Code and Corporate Governance Code, dialogue between companies and investors has gained momentum, and more companies are aware of cost of capital. However, many investors still feel that much work remains when it comes to initiatives aimed at raising corporate value.
- » Now that companies are in their "second round" of adapting to the Corporate Governance Code, there has been progress with evaluations of effectiveness of the board of directors and the appointment of multiple independent directors. Overall, the percentage of companies complying with the Code is rising.
- » There has been progress on the formality side of corporate governance, such as the appointment of independent directors, the transition to a Company with Audit and Supervisory Committee system and the establishment of optional advisory committees on nomination and remuneration.



1 Dialogue gathering momentum

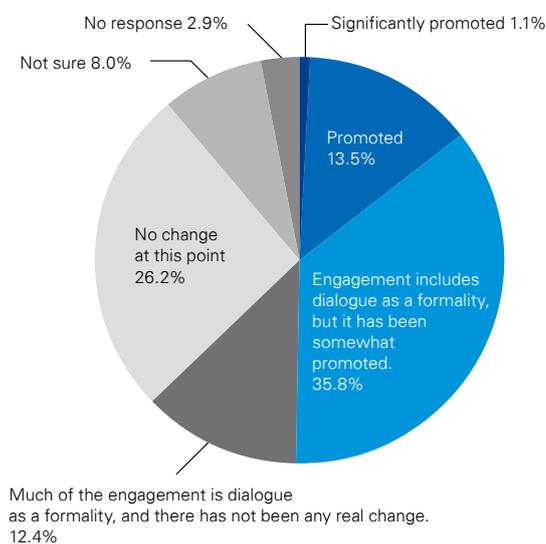
Making progress with dialogue

Since the establishment of Japan's Stewardship Code and Corporate Governance Code (hereafter referred to as "the double codes" in this report), dialogue between companies and investors has gained momentum. According to a survey conducted by the Japan Investor Relations Association, about half of the companies surveyed responded that dialogue with investors has been "promoted" or "somewhat promoted," which indicates that companies are seeing some progress in dialogue with investors (Figure 4).

Companies and investors are making progress with dialogue in two areas. The first is dialogue with the institutional investors responsible for asset management. This refers to dialogue with the analysts and fund managers involved in investment decisions.

The other area in which progress has been made is dialogue with institutional investors' governance managers. This often refers to dialogue with the manager in charge of exercising proxy voting rights, but in the case of US and European institutional investors in particular, they not only cover proxy voting, but also discuss issues related to the very core of management, such as corporate governance systems, director compensation and risk, from a medium- to long-term perspective. In addition, depending on business characteristics, this includes initiatives with research and development and technology and the scope of dialogue regarding human resources.

■ Figure 4. At this point, has dialogue with institutional investors been promoted with the aim of sustainable growth for the company? (n=614)



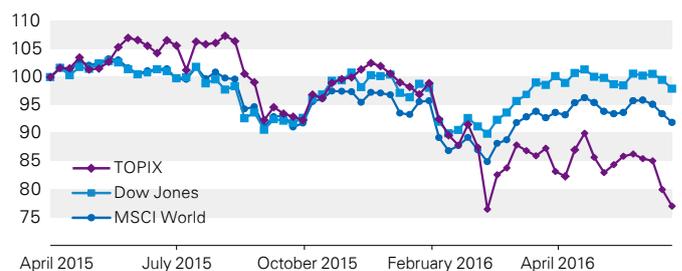
Source: Japan Investor Relations Association's Survey on IR Activity (April 2016)

Changes in awareness of cost of capital

Institutional investors on the asset management side have long pointed out that Japanese companies' capital productivity is low. However, their awareness seems to be changing ever since the double codes were established. More companies are managing operations with an awareness of cost of capital, an awareness which is the basic factor when discussing capital productivity. According to the questionnaire, about half of 960 listed companies are aware of their own company's cost of equity.

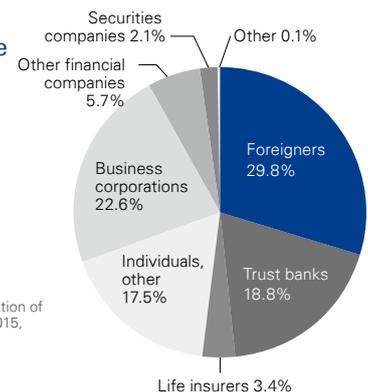
At the same time, Japan's share performance has fallen substantially, and shareholder composition has also changed. Share performance since April 2015 shows that TOPIX underperforms major global indices (Figure 5). In conjunction with this, foreign investors, who account for the highest turnover in Japan's stock market, have become net sellers. Their holdings account for 29.8% of the stock market, down about 2% over the previous year (Figure 6). The fact that foreign investors, who have a strong preference for risk, have become net sellers and that the Japanese stock market is underperforming major indices suggests that there are still many investors who are not confident in Japanese companies' ability to raise corporate value sustainably.

■ Figure 5. Share indices since April 2015



Source: Prepared by KPMG using SPEEDA from UZABASE, Inc. (indexed with April 1, 2015 as 100).

■ Figure 6. Shareholder composition of Japanese companies



Source: TSE's Results of Survey on Distribution of Shareholdings by Investor Type for Fiscal 2015, June 20, 2016

2 — Status of code compliance

Japanese companies' approach to corporate governance is changing significantly since the adoption of the Corporate Governance Code. In Japan's corporate sector, mega-banks have carried out governance under industry regulations and bank financing since the post-World War II reconstruction and high-growth period.

In response, the Corporate Governance Code incorporated global standards based on the OECD principles, and used external directors for the supervisory function. This code supported transparent, equitable, prompt and bold decision-making and gave more respect to the improvements in corporate value that shareholders sought, essentially overthrowing Japanese companies' classical standard.

Response to "the second round" of the Code

In June 2016, many companies whose fiscal years end in March had held their regular shareholders' meetings and disclosed their second "comply or explain" comments in their Corporate Governance Reports.* Over 80% of companies explained in the first fiscal year in which the code was adopted by the end of March 2016 ("the first round"). How has this trend changed?

*Report Concerning Corporate Governance stipulated in Rule 419 of the TSE's Securities Listing Regulations

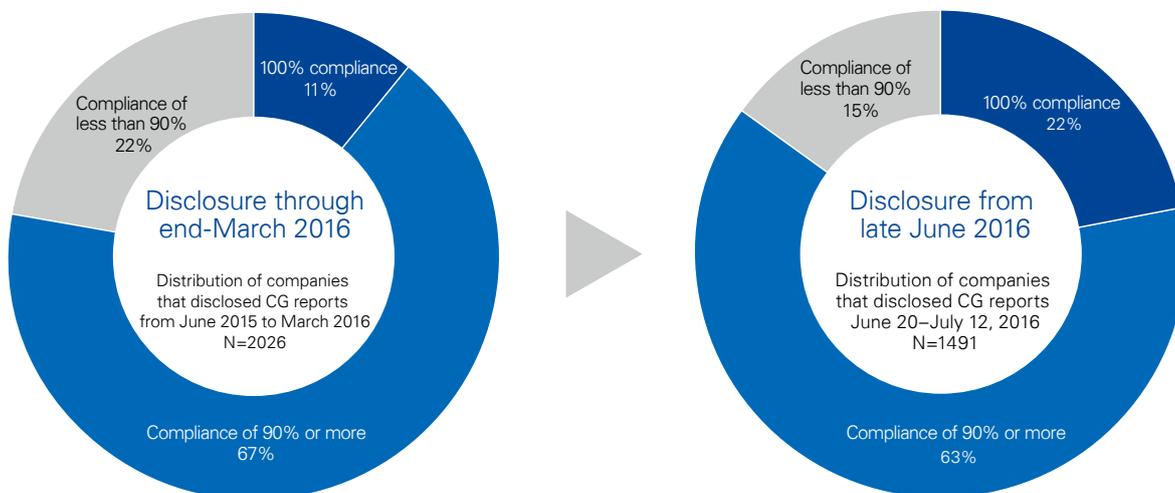
Of the 73 principles in the Code, a comparison of the percentage of the principles with which companies complied ("compliance rate") has increased more for the companies who disclosed reports from the June general shareholders meeting than for the companies who disclosed by the end of March 2016, as shown in Figure 7. Companies with a 100% compliance rate increased to 22% from 11%, and the percentage of companies with a compliance rate of less than 90% fell to 15% from 22%.

In light of the intentions of the Corporate Governance Code, although many companies understand that it is not necessarily appropriate to comply with the code as the principles state, it is deemed that in the medium term, many companies will establish corporate governance systems that do not violate the direction of the code. Accordingly, we expect the compliance rate to rise.

At the same time, an analysis of the explanations of companies that did not comply with the principles shows progress in addressing several measures. This could be one of the reasons for the increased compliance rate in the second round.

Figure 8 shows the ranking of principles with a high "explanation" rate. Many companies have not yet been able to conduct evaluations of the effectiveness of the board (Supplementary Principle 4.11.3) and appoint at least two

■ Figure 7. Change in the percentage of "comply or explain" (companies listed in the first and second sections of TSE)



Percentage of companies complying with all of the principles doubles in second round of disclosure

Source: Prepared by KPMG based on companies' individual corporate governance reports

independent directors (first paragraph, Principle 4.8), but the percentage of companies explaining rather than complying with the two principles fell to about 20%, or to 63.9% from 39.0% and to 19.7% from 39.2%, respectively. As such, the ranking is falling. At the same time, the percentage of companies providing an explanation for the creation of an infrastructure allowing for electronic proxy voting and the provision of English translations of the convening notices for general shareholder meetings (Supplementary Principle 1.2.4) and performance-based compensation for officers has dropped to 54.3% from 57.9% and to 30.4% from 31.7%, respectively, which is not a very significant decline. This indicates that many companies have not yet made much progress in these areas.

■ Figure 8. Principles with a high explanation rate

Through May 2016			Updates in June 2016			
4.11.3	Evaluation of board effectiveness	63.9%	1.2.4	Infrastructure allowing for electronic proxy voting and the provision of English translations of the convening notices for general shareholder meetings	54.3%	↑
1.2.4	Infrastructure allowing for electronic proxy voting and the provision of English translations of the convening notices for general shareholder meetings	57.9%	4.11.3	Evaluation of board effectiveness	39.0%	↓
4.8	Appointment of at least two independent directors	39.2%	4.2.1	Performance-based management remuneration	30.4%	↑
4.2.1	Performance-based management remuneration	31.7%	3.1.2	Information disclosure and provision in English	26.8%	↑
4.10.1	Establishment of optional advisory committees	28.8%	4.10.1	Establishment of optional advisory committees	25.5%	→
3.1	Information disclosure	26.9%	4.8	Appointment of at least two independent directors	19.7%	↓
3.1.2	Promoting information disclosure and provision in English	26.9%	4.8.2	Appointment of a lead independent director	16.2%	↑

Source: Prepared by KPMG based on companies' individual corporate governance reports (submissions made by May 31, 2016 and submissions made June 20–July 12, 2016)

3 Progress of reform on the “formality” side of corporate governance

Increase in appointment of independent directors

There has been significant progress in the appointment of external directors and independent directors (Figure 9). Under the 2014 revised Companies Act, companies are required to provide an explanation if they do not appoint external directors. This has led to substantial gains in the percentage of listed companies (first section of the TSE) that appoint external directors, from 74.3% to 94.3% in 2015 and up another 4.5% over the previous year in 2016 to 98.8%. Moreover, in 2016, 79.7% of listed companies (first section of the TSE) had appointed at least two independent directors, which is recommended in the Corporate Governance Code (first paragraph, Principle 4.8), up 31.3% over the previous year. This indicates that, as noted above, many companies are complying with the code. Moreover, there has also been an increase in the companies in which over one-third of the directors are independent directors (second paragraph, Principle 4.8). According to companies’ corporate governance reports as of August 30, 2016, 33.8% of the companies listed in the Nikkei 225 have already disclosed that one-third or more of their directors are independent directors (KPMG’s findings).

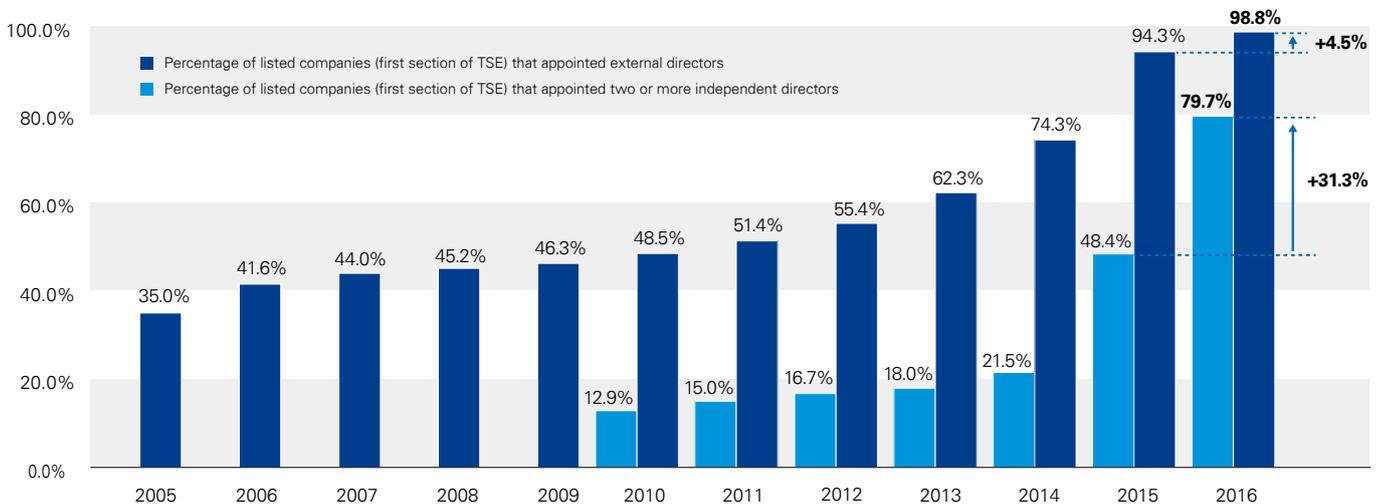
Increase in adoption of Company with Audit and Supervisory Committee system

The number of companies with audit and supervisory committees is also increasing, keeping pace with the rise in the number of companies appointing external directors. As shown in Figure 10, as of the end of July 2016, 646 listed companies had moved to a Company with Audit and Supervisory Committee system. According to the publicly released information from the companies, the reasons for moving to a Company with Audit and Supervisory Committee system can be categorized as follows.

1. To reduce the burden and overlap in the case of appointing two independent directors
2. To speed up management decision-making by transferring decision-making authority over important operations
3. To develop a governance structure that is easy for foreign investors to understand

At the same time, simply replacing the Kansayaku Board with an Audit and Supervisory Committee undermines the effectiveness of the framework that gives Kansayaku powerful auditing authority, which is based on their independence and their right to initiate audits on their own. In addition, the shift to a Company with an Audit and Supervisory Committee system can be seen in a negative light since the board of directors’ supervisory powers over business execution

■ Figure 9. Appointment of external directors and two or more independent directors



Source: Prepared by KPMG based on TSE’s “Status of Appointment of Independent Directors by Companies Listed on First Section of TSE (Finalized Report)” (July 27, 2016)

are not the same as in a Company with Three Committees (Nomination, Supervisory, and Remuneration) system. The Audit and Supervisory Committee has the right to state its opinions on matters related to human resources and compensation for directors that are not members of the Committee at general shareholders meetings. However, when moving from a Company with a Kansayaku Board system to a Company with Audit and Supervisory Committee system, as noted below, the key points are to what extent the independent directors involved in the process of nomination and determination of remuneration can maintain the audit and supervisory functions, as sought, for example, by the establishment of an optional advisory committee on nomination in which independent directors are primary members.

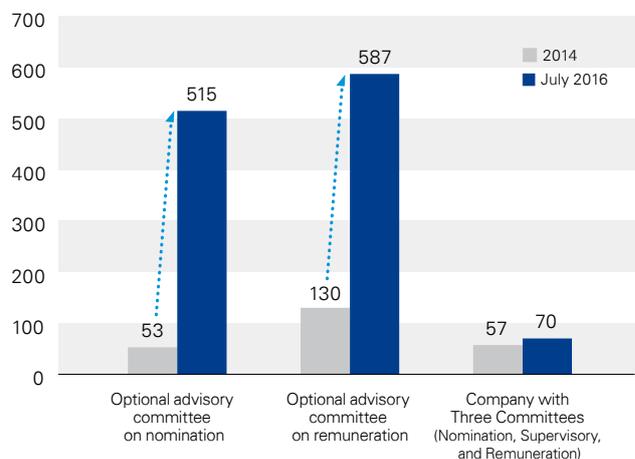
Increase in companies establishing optional advisory committees

According to the Corporate Governance Code, if a company adopts either a Company with Kansayaku Board system or a Company with Audit and Supervisory Committee system, while independent directors do not make up a majority of the board, the company may reinforce the independence, objectivity and accountability of the board of directors' functions related to the nomination and remuneration of senior management and directors by seeking the appropriate involvement and advice of independent directors when considering particularly important issues such as nomination and remuneration. One way to do this is to establish optional advisory committees under the board in which independent directors play a role (Supplementary Principle 4.10.1).

As a result, the number of companies that had established optional advisory committees on nomination and/or remuneration is increasing. As of the end of July 2016, the number of listed companies that had appointed optional advisory

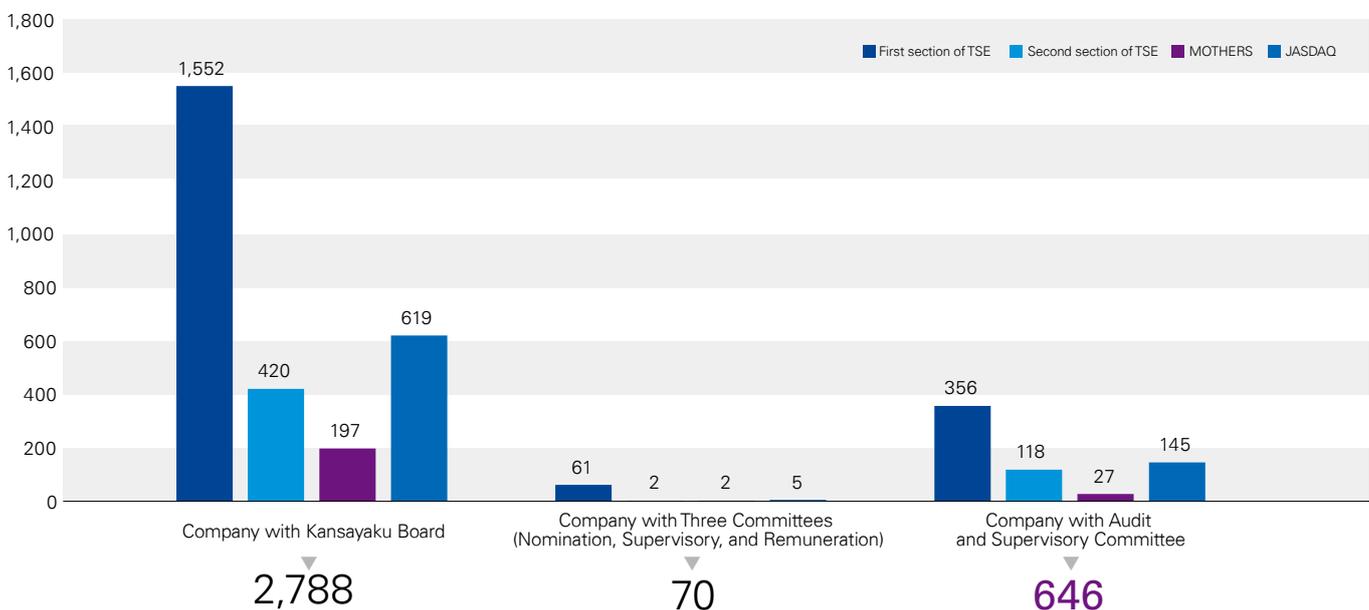
committees on nomination had jumped from 53 to 515 compared to 2014, and the number of companies that had established advisory committees on remuneration had climbed from 130 to 587 (Figure 11). However, unlike the nomination committee and remuneration committee in a Company with Three Committees (Nomination, Supervisory, and Remuneration), these advisory committees are only optional, and their role, constituent members and activities are varied. There may also be issues with lack of transparency. When an optional advisory committee is established, it is important to ensure transparency, for example by actively disclosing its role, members and proceedings.

■ Figure 11. Establishment of optional advisory committees



Source: Prepared independently by KPMG using page 62 of TSE's Corporate Governance White Paper 2015 on TSE First Section Listed Companies" (March 2016) for 2014 data and TSE's "Corporate Governance Information Service" for end-July 2016 data.

■ Figure 10. Selection of organizational system by listed companies (as of end-July 2016)



Source: Prepared independently by KPMG using TSE's "Corporate Governance Information Service"

III.

Pursuing the optimal corporate governance system

POINT

- » In order to maximize the effectiveness of the formality side of the reforms carried out under the Corporate Governance Code, the role of the board of directors needs to be revisited.
- » In carrying out operational reforms to revitalize the board of directors, it is critical to ensure the transparency of the nomination and selection process for directors and senior managers, and it is equally vital to carry out reforms in talent management to bring up the next generation of managers.
- » A clear vision for the company, progress management and ongoing improvements are crucial in moving ahead steadily with reforms tailored to the company's own business and scale. The specific method for achieving this is conducting evaluations of the effectiveness of the board of directors.

1 — Trends in corporate governance reform among Japanese companies

Results from first year of governance reform and pending issues

As described in “II. What changed as a result of the double codes?”, the Corporate Governance Code has achieved some positive results: these include an increase in the appointment of independent directors, more companies adopting a Company with Audit and Supervisory Committee system, and greater appointments of optional advisory committees. These steps were a direct response to the 2014 revised Companies Act and the Corporate Governance Code, and brought about changes on the formality side.

Changing the governance system from a Company with Kansayaku Board system to a Company with Audit and Supervisory Committee system or a Company with Three Committees (Nomination, Supervisory, and Remuneration) system takes numerous steps of consideration and procedures, involving serious manpower and costs. From the company’s perspective, these are very big decisions. Demonstrating this commitment to reform through changes on the formality side is laudable, and the first year of reforms resulted in a steady start, as expected.

However, as is clear in the examples of past corporate scandals, there are innumerable examples in which an admirable organizational system has been robbed of any substance when it came to operations. Corporate governance reforms in Japanese companies have just gotten underway, and many issues still remain.

What approach should Japanese companies take with their reforms?

So what kind of reform is needed to ensure that corporate governance of Japanese companies, premised on regulation and stable management, functions as a structure aimed at achieving true gains in corporate value?

While steadily moving ahead with the formality side of reform in the first stage, it is vital that companies progress to the next stage starting in the second year with reform in board operations and talent management. As described above, the formality side of reform refers to externally driven reforms such as changes to organizational system and an increase in external directors. However, without directors able to support the operation and mechanisms of these institutions, the expected functions will not materialize. In order to ensure that the results of the formality side of reform function effectively, initiatives to optimally operate institutions such as the board of directors and securing and developing directors with the needed skills are essential.

■ Figure 12. Transition from the formality side of reform to reforms of operations and talent of board members



Reforms in operations

Operational reforms are indispensable in raising the effectiveness of reforms on the formality side of corporate governance that have been carried out such as increasing the number of independent directors or changing the organizational system.

Without changing the way in which the board of directors operates, the effect cannot be adequately realized even if more independent directors are added. In order to truly utilize the expertise of independent directors in devising strategies and revitalizing debate in the board of directors the first step is to clarify the issues to be discussed in the board of directors meetings, while entrusting the execution of business operations to executive officers. The issues debated by the board of directors under a monitoring model are normally corporate ethics, strategies, mid-term management plans, etc.

Moreover, providing adequate information on the agenda to outside directors before the meeting is also a critical point. More companies are not only passing out materi-

als before the meeting, but are taking considerable time to explain the agenda to outside directors at an earlier stage. The proceedings of the board of directors are not meant to simply affirm agenda items that have essentially already been decided internally. Rather, an effective board will hold constructive discussions on each issue, asking whether the best choice was made on the execution side after exhaustive discussion and whether risks taken on as a result of a decision on a proposal are within an acceptable range. Independent directors are responsible for maximizing corporate value and occasionally making statements that encourage business execution. In contrast, it is important that internal directors accept the views of independent directors in order to boost corporate value, determine whether the proposal is feasible in light of business conditions and, when necessary, express disagreement.

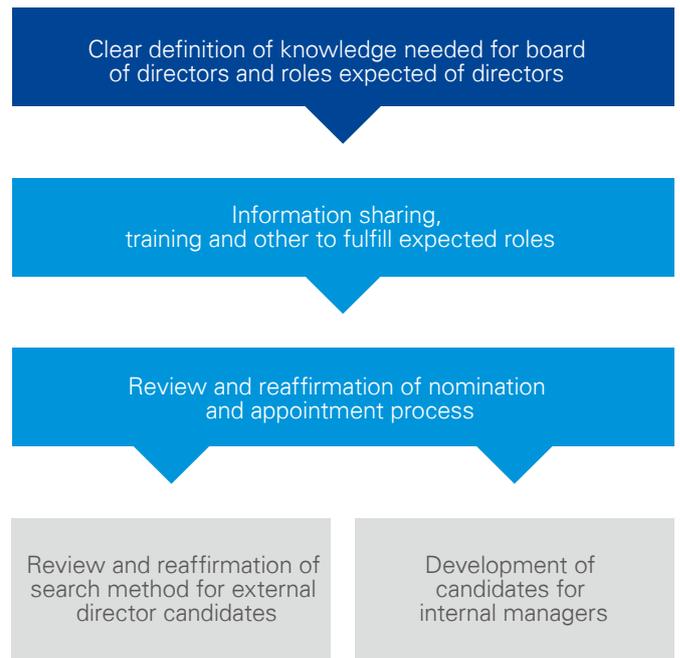
Reform in talent of board members

Many talented managers claim that “the quality of the members ultimately determines the quality of corporate governance.” This does not mean that as long as a company has

■ Figure 13. Specific examples of operational reforms



■ Figure 14. Measures needed for reforms in talent



good human resources, its corporate governance will also be good. Rather, a company with adequate human resources who are able to actually move ahead with initiatives to execute the aforementioned reform on the formality side as well as reforms in operations can maximize the effect of its corporate governance reforms.

When thinking about “talent” in the context of the board of directors, an issue shared by Japanese companies is the nomination and appointment process for directors on the board and senior management. In particular, at many companies the designation of a successor is essentially the prerogative of the current president. Since the appointment of management members is the nucleus of corporate governance and the company’s most important topic for decision-making, it is often observed that lack of transparency in this process is a problem. In addition, companies need mechanisms for the dismissal of managers based on appropriate evaluations on performance. There are also concerns that even after retirement, the former president and chairman of the board exercise influence over the appointment of presidents on an informal basis from the position of a non-di-

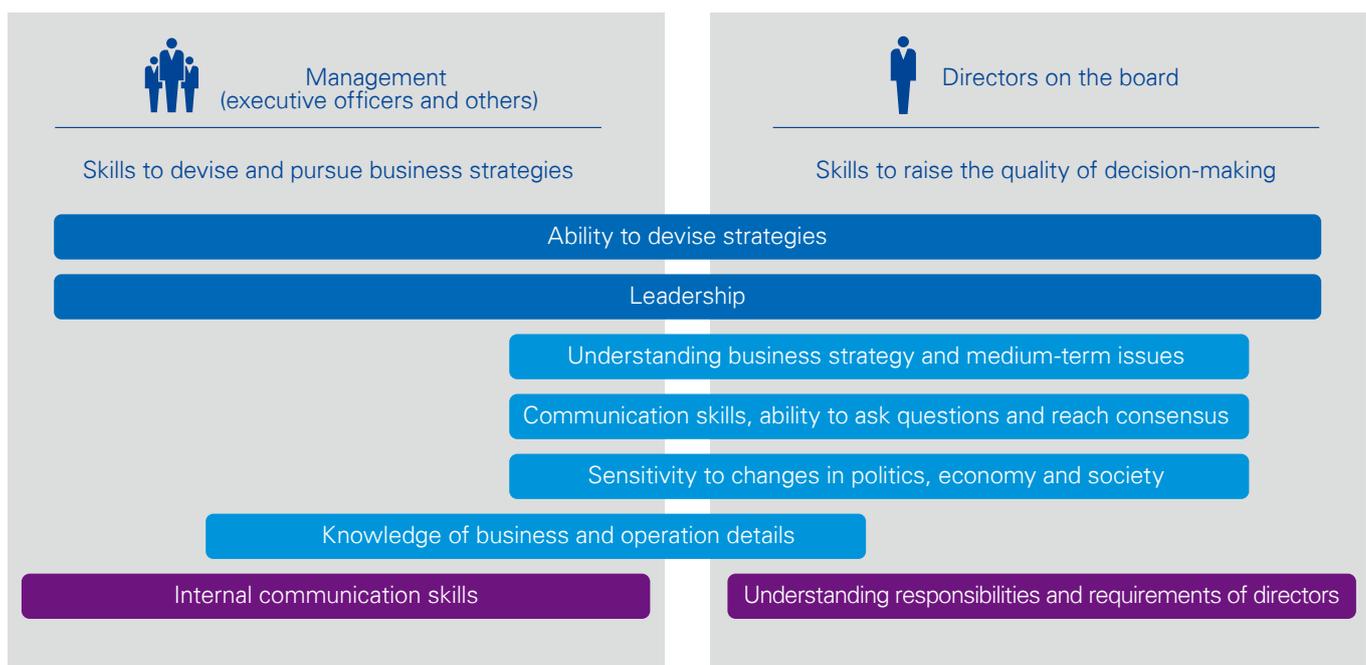
rector who provides advice.

To address this issue, even under a Company with a Kansayaku Board system, there are a growing number of companies that give optional advisory committees on nomination and remuneration the function of proposing the designation of directors and remuneration proposals. However, even this does not necessarily guarantee the objectivity of the process, depending on the composition of the advisory committee. While it is difficult to make the nomination processes completely transparent, independence and objectivity from management can be secured by making needed adjustments to operations, such as strengthening the authority of the independent directors on the advisory committee.

Next, there are issues with “the search for outside director candidates,” “director training” and “bringing up the next generation of management.”

Ensuring the effectiveness of the board of directors is premised on a balance in the quality of board members and augmenting their diversity. Accordingly, it is best to view the qualities of board members as a portfolio to

■ Figure 15. Knowledge that is expected from directors on the board (example)



identify the areas in which expertise is insufficient and the areas in which deeper knowledge is required.

In general, the executive officer who is responsible for the business execution departments and the director responsible for supervising management overall need expertise in different areas. Given this, when the roles and responsibilities of a person change from an executive officer to a director, acquisition of knowledge and training are clearly essential. Selecting and training talent that can broadly cover the knowledge needed for the board of directors is also an effective strategy for bringing up the next generation of management and directors.

To achieve this, identifying and managing a portfolio of management candidates (talent management) throughout the company (including overseas) is very important.

Moreover, particularly when selecting outside director candidates, it is necessary to clarify what the company expects from them. If the director is expected to raise corporate value and back up the capacity to generate profits, someone with experience in corporate management would be appropriate. If the director is expected to have expertise in law and accounting and closely examine and rein in risks, the candidate should be a specialist such as a lawyer or certified accountant. Since it might not be possible to select a candidate based on these expectations from a limited pool, more companies are expected to utilize consulting services such as executive search services. Newly appointed directors often attend lectures and are given training on basic knowledge such as the legal responsibilities of a director. However, given that knowledge about the company's own basis will need to be augmented in light of the aforementioned knowledge needed as

a director, many companies also provide tours of factories, stores and overseas bases.

It is important to provide incentives such as remuneration to management and executives, in order to secure talented human resources from both within and outside of the company. The percentage of fixed compensation is high in Japan, and as noted above, there has not been much progress with mechanisms for performance-based compensation for directors, as laid out in the Corporate Governance Code. Nevertheless, initiatives are underway to facilitate the introduction of steps to clarify tax treatment, and further consideration is needed.

Debate over the "formality side" of corporate governance in terms of systems and mechanisms has moved ahead, but as noted above, the key to their success lies in securing and training directors. Carrying out talent reforms is a major factor in the success of corporate governance reforms.

■ Figure 16. Examples of measures taken for reform on the formality side, reform in board operations, and reform in talent of board members



2 — Board evaluation to achieve continuous improvements in board function

Steady progress with reforms

As we have seen thus far, corporate governance reforms are in the midst of medium-term initiatives that shift the focus from “formality” to “board operations” and “talent management.” Moving ahead with reforms tailored to the company’s own business and scale requires a clear vision, progress management and ongoing improvements. One specific means of achieving this is to evaluate the effectiveness of the board, as described in Supplementary Principle 4.11.3 of the Corporate Governance Code.

Objective of board evaluations and definition of “effectiveness”

The Corporate Governance Code stipulates and requires that the effectiveness of the board overall should be analyzed and evaluated in order to improve board function, and the results of this analysis and results of the evaluation should be disclosed every year, as noted below.

Supplementary Principle 4.11.3

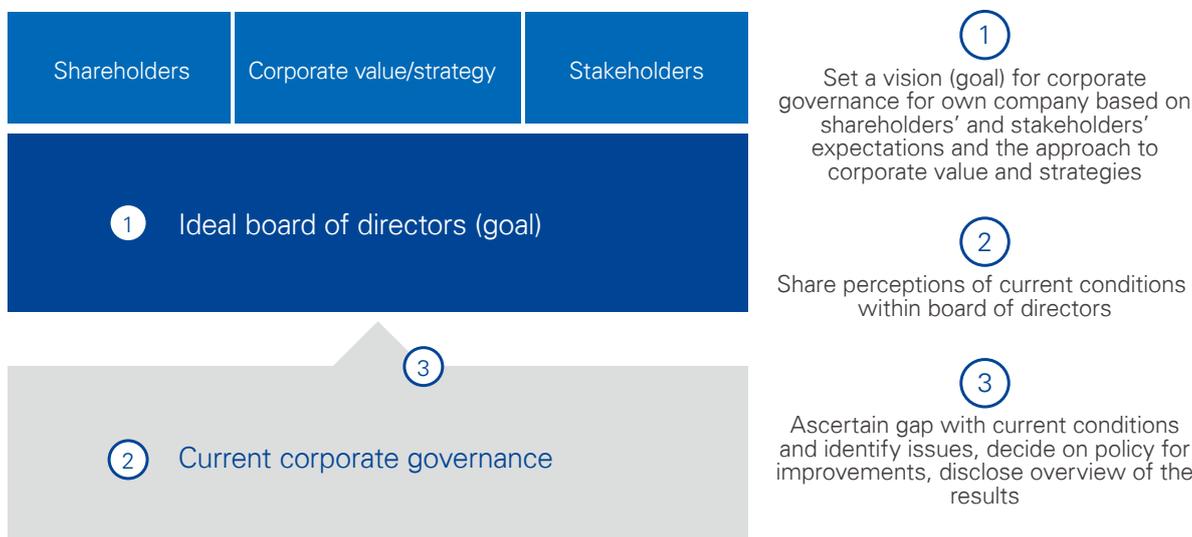
Each year the board should analyze and evaluate its effectiveness as a whole, taking into consideration the relevant matters, including the self-evaluations of each director. A summary of the results should be disclosed.

How should the effectiveness of the board of directors be evaluated? To understand this, we have to consider the objective of board evaluation.

In Japan, evaluations are generally spoken of as if the objective is to earn a positive evaluation, asking whether the target of the evaluation met objective standards or how many points out of 100 were earned. However, this approach would not work well in an evaluation of the effectiveness of the board. This is because the role that the board of directors is expected to play and the vision to which it aspires differs depending on the business environment, business strategy and investor expectations of each company, so setting uniform “objective standards” would be meaningless. The Corporate Governance Code lays out a specific direction, but the specific roles that a board of directors should play to raise corporate value in the medium term is in many respects unique to each company.

A proper evaluation of the effectiveness of the board aims to identify issues by examining the gap between the company’s vision for its board of directors and actual practice, with a view to raising corporate value, and then lay out a path for improvement. When evaluating effectiveness, the ideal criteria for evaluation is “achievement of the company’s own vision for its board of directors.”

■ Figure 17. Approach to evaluation of the effectiveness of the board



Practical tasks involved in board evaluation

So, when using “achievement of the company’s own vision for its board of directors” as the evaluation criteria, what specific perspectives and items are employed? Since evaluations of board effectiveness have almost never been carried out until now, there are few examples that can be used as references in Japan. Accordingly, using cases overseas as a reference provides a shortcut to learning about the practical work involved in the evaluation.

KPMG has laid out the evaluation perspective and evaluation items in line with the intent of Japan’s Corporate Governance Code, based on overseas examples in the UK and elsewhere, as shown in Figure 18. The company’s vision is defined for each of these evaluation perspectives and evaluation items, and the extent to which they have been achieved at this point is evaluated using this as the standard.

Interviewing directors or having them fill out a questionnaire is a typical evaluation method. Since insufficient information would be obtained from a questionnaire in order to evaluate areas in which many elements are interrelated in a complex manner, as is certainly the case in corporate governance, combining questionnaires with interviews of the directors would be effective.

The evaluation covers the effectiveness of the board of directors, and the evaluation’s target is the board of directors. However, Kansayaku Boards and committees on business execution (management committees, etc.) tend to be involved in the corporate governance of Japanese companies, so evaluating the effectiveness of the board of directors using only directors as the source of information would not be appropriate. The Kansayaku Board and its individual members, as well as key executive officers, should be asked for their views to determine whether the board is fulfilling its expected functions.

The objective of the evaluation of board effectiveness is to identify issues by examining the gap between the vision for the board and actual conditions with a view to raising corporate value, and then to lay out a path for improving conditions. As such, it is not enough to simply determine whether the board is effective or not; rather, it is vital that issues be identified and the direction of improvements considered. Companies would do well to identify issues related to reforms in board operations and the talent of board members, so that the evaluation is an opportunity to move ahead with reforms.

As noted above, even given that there are no objective evaluation criteria, a third-party evaluation in which an external party takes the lead role in the evaluation is not necessarily needed, and this is primarily a self-evaluation. However,

■ Figure 18. Evaluation perspective and key points at issue

No	Evaluation perspective	Key points
I	Role and responsibilities of (board of) directors	Establishment of management principles, formulation of management strategies, succession plans, etc., with a view to building a foundation for improving corporate value over the medium to long term
II	Relationship between board of directors and managers	Appointment and dismissal of managers, risk management and compliance, status of execution, reports and supervision
III	Design and composition of organs including board of directors	Organizational design, use of external directors, establishment and administration of optional committees
IV	Quality and knowledge of (board of) directors	Knowledge, capacity, experience, independence and diversity of external directors, training
V	Discussions at board of directors	Revitalization of discussions at board of directors, system for obtaining information and support, use of external directors
VI	Relationship and dialogue with shareholders	Ensuring rights of shareholders, shareholder response, augmenting information disclosure, constructive dialogue with shareholders
VII	Response to stakeholders other than shareholders	Response to social and environmental issues, ensuring diversity of employees, respect for employees, communication with stakeholders

Source: “‘Board Evaluation’ sought by the Corporate Governance Code?”, KPMG Insight September 2015 edition

incorporating outside opinions is extremely effective in assessing current conditions more objectively and considering ways to improve issues from a broader perspective. There are many cases in which independent directors play this role, but given that independent directors are also covered in this evaluation, obtaining advice from experts once every few years would be a useful approach (in the UK system, it is recommended that external experts be involved at least once every three years).

Disclosure of overview of results of board evaluation

Many of the companies that held ordinary general shareholders meetings in June 2016 updated their corporate governance reports and disclosed an overview of the results of their evaluations of board effectiveness for the first time. Supplementary Principle 4.11.3 had a low compliance rate (percentage of companies not providing an explanation) in the first year of adoption, as noted above, but as of June 2016 the number of companies complying with this principle had increased sharply.

However, there are also cases in which, judging from the disclosure, the evaluation has not adequately considered the code's intent. Examples of some disclosures are below.

- Cases in which the companies merely stated "We decided to carry out an evaluation" or "we will carry out an evaluation in the future," without disclosing the evaluation results
- Cases in which companies failed to mention the evaluation criteria and methods and the issues that were identified, but simply declared that "there are no doubts about board effectiveness"
- Cases in which the board was deemed to be "effective" based on extremely low-level criteria, such as "the board of directors carried out active discussions in board meetings"
- Cases in which the board was judged "effective" based on "evaluations of managers" carried out for other purposes in other systems, such as an internal control evaluation on the validity of financial reporting and audits

Although the requirements for compliance are not rigorously laid out in the "comply or explain" system, in the aforementioned examples, the above examples do not indicate that the boards of directors at those companies are making improvements to reach their vision in order to raise corporate value. This falls somewhat short of the bar for compliance.

The practice of board evaluation in Japan will gradually be established, but we recommend that companies' disclosures be compared in terms of whether the evaluation and disclosure lack real substance and whether the evaluation is consistent with the goal.

Disclosure with a story

As already noted, the purpose of board evaluation is to evaluate the extent to which the company's board of directors is being run in line with the vision and to lay out a path for improvements. However, disclosing an overview of the evaluation results is also a means of highlighting the efforts of the board to raise corporate value (achieve expected revenue) to shareholders and investors.

One financial institution in Japan discloses not only the evaluation results and methods, but also the history and context of its initiatives with corporate governance thus far. They disclose the evaluations and initiatives currently underway, and speak of past initiatives and the relationship to the current evaluation and the direction for the future as a chronological story. This provides a persuasive explanation on how much the company's corporate governance has grown and how it led to medium- to long-term gains in corporate value. This is a good example of the way in which a company can carry out evaluations and disclose information not only for compliance, but also to present the appeal of its own corporate governance by telling stakeholders such as shareholders and investors a succinct story.

Boards of directors are extremely busy at all companies, and do not necessarily have enough time to spend on annual evaluations of effectiveness. Since limited time, labor and money is spent on this evaluation, the disclosure should be easy to understand and should accurately play up the company's corporate governance. To this end, it is extremely important to carry out a solid evaluation and disclose the evaluation results in the form of a "story" of the company's own corporate governance.

IV.

Dialogue with investors and approaches to corporate disclosure

POINT

- » Given the disparities in perceptions of “corporate value” between companies and investors, dialogue that contributes to improving corporate value is important. The approach to this dialogue includes strengthening the analysis of one’s own company’s corporate value as well as disclosure of non-financial value in correlation to financial value.
- » Since investors’ confidence in management is manifested as proxy votes at shareholder meetings, the board of directors has a major role to play, and approaches to corporate governance—the foundation for improving corporate value—are in the spotlight.
- » There are many boilerplate phrases used in the corporate governance reports that have been released, and various problems have been pointed out, including the quality of the items that were “complied with” and a lack of specifics in the items that were “explained.”

1 — Objective and the necessary perspective of the dialogue

Objective of the dialogue

The Corporate Governance Code states, “In order to contribute to sustainable growth and the increase of corporate value over the medium to long term, companies should engage in constructive dialogue with shareholders even outside the general shareholder meeting.” Also, the Japanese Stewardship Code notes that “improving and fostering the investee companies’ corporate value and sustainable growth” is the objective of “constructive engagement.” In other words, dialogue ought to be carried out with the aim of improving corporate value.

Disparities in perceptions of corporate value between companies and institutional investors

However, as demonstrated by the results of a survey,^{*} a mere 23% of institutional investors in Japan and overseas are satisfied with Japan’s corporate governance. This implies that institutional investors are not impressed with the current situation of corporate governance in Japan. What institutional investors expect from corporate governance is returns—in other words, improvement of corporate value. The results of this survey suggest that the current view of institutional investors is that Japan’s corporate governance reforms are not leading to improved corporate value and are not boosting returns. This is due to disparities in the perspectives of Japanese companies and institutional investors on corporate value.

^{*} Dr. Ryohei Yanagi, Visiting Lecturer, Waseda Graduate School of Accountancy, and CFO of Eisai Co., Ltd. (Fiscal 2015)

This disparity occurs in two areas.

The first disparity lies in the definition of corporate value itself. Japanese companies do not have a uniform definition of corporate value, but use the phrase to mean the summation of the added value offered by the company to stakeholders, including shareholders. This is not incorrect, but this definition is not a concept that can be easily quantified, and sometimes cannot satisfy investors’ requirements.

Second, Japanese companies have not been able to quantitatively ascertain investors’ expectations. Even in the case of companies that have ascertained the level of expectations, those perceived by the company and those of the investors differ. When referring to “expectations” in this context, we

are referring to cost of equity for the company, or expected rate of return for investors.

As long as there are such disparities in this perception, dialogue is unlikely to contribute to improvement of corporate value.

Incorporating investors’ perspective in management

Dialogue ought to contribute to improvement of corporate value, but since corporate value for investors from a long-term perspective is based on the “discounted value of future cash flow,” corporate value would not improve unless the generation of free cash flow increases or cost of equity declines. Moreover, corporate value cannot be said to have improved for investors unless companies generate returns that exceed cost of equity—i.e., investors’ expected rate of return.

Long-term investors analyze the future prospects of companies in detail and then invest in companies that are expected to generate returns that exceed their expected rate of return. These investor expectations are priced into medium- to long-term share prices as market participants’ consensus, and as a result, value exceeding book value is reflected into the share price (Figure 19).

The General Principle 5 of “Section 5: Dialogue with Shareholders” in the Corporate Governance Code lays out the following approach:

Regularly engaging in dialogue with shareholders to gain their understanding of specific business strategies and business plans and taking appropriate action when there are concerns are extraordinarily useful for companies to strengthen the foundations of management legitimacy and support their efforts to generate sustainable growth. [omitted] If the senior management and directors give due attention to the views of shareholders through dialogue, they can absorb views and analyses of business management from the perspective of capital providers. Dialogue with shareholders also ought to inspire healthy entrepreneurship in the management and directors and thereby contribute to sustainable corporate growth.

This implies that there is a chance for management to gain insight that helps them to improve the generation of free cash flow by incorporating investors' views into management.

Investors do not have as detailed an understanding of the company as management. However, in the process of conducting research on companies and their peers in related industries, investors may have identified industry trends and advantages of individual companies from a different perspective.

Institutional investors who invest globally analyze the positioning of each company in detail by comparing them to their global peers.

By engaging in dialogue with these investors, management will be able to gain insights on their business strategy and their company's position in the global competitive environment. In addition, there might be opportunities for discussion on the investor's perception of business strategies and financial strategies of peer companies. On the other hand, investors are not advisors to management. Even if management wants to gain insights from investors, dialogue will end in one-sided questions from investors unless management improve their ability to engage.

Visualization of corporate value and the governance system

In improving the ability to engage in dialogue, having a clear focus for the company's business strategy and financial strategy is essential, but a clear-headed analysis of the current share price (market evaluation) is also necessary. Share prices tend to fluctuate in the short term, but they reflect corporate value in the medium to long term. The dialogue can extend into topics that are materially important if companies have a clear understanding of the grounds on which the evaluation of the company is formed in the market. To do so, it is important to visualize the factors that make up the value of the company (value drivers) and specify the factors that contribute to improving corporate value.

This endeavor leads to an understanding of the quantitative as well as qualitative aspects of investor expectations. The disparities in the perception of corporate value between companies and investors can be narrowed

through repeated dialogue held on the basis of a quantitative understanding of investor expectations.

Still, these initiatives are not effective if the CEO and the CFO are the only ones involved. It is critical that the board of directors be involved, with a shared understanding of the significance of such dialogues. Investors expect corporate governance to result in improved corporate value (returns), and they will not be impressed unless the board of directors runs the company with this same goal.

Ascertaining investor expectations in a quantitative sense and utilizing this in a dialogue with investors requires a willingness to take risks—in other words, boards of directors are expected to share the recognition of cost of equity, set an appropriate hurdle rate based on this recognition and accelerate investment while weighing risks to raise returns. This perspective is also essential in considering the introduction of independent directors and changes to institutional design involved in corporate governance reforms.

Disclosure of non-financial value utilizing integrated reporting

In ensuring that dialogue is fruitful, initiatives aimed at strengthening disclosure of non-financial value are important. It is vital that disclosure of non-financial value be strengthened with a focus on the correlation with financial value, taking into account growth strategies, capital efficiencies and financial strategies. It is a fact that corporate value for long-term institutional investors is "discounted value of future free cash flow," but the capital that generates free cash flow is not necessarily limited to financial capital. Management utilizes a wide range of capital, including human capital and social capital, to generate value.

While this kind of capital is often hard to quantify, the portion that creates value in management activities is gradually reflected in market value (share price). Integrated reporting (refer to Column, page 29) is not necessarily directed solely at investors, but even so, encouraging dialogue between companies and investors by utilizing integrated reporting would raise investors' confidence in companies over the medium to long term and lower cost of equity, thus contributing to improved corporate value.

Should disclosure and utilization of non-financial information advance widely, progress is expected to be made in disclosure contributing to investors' decision-making.

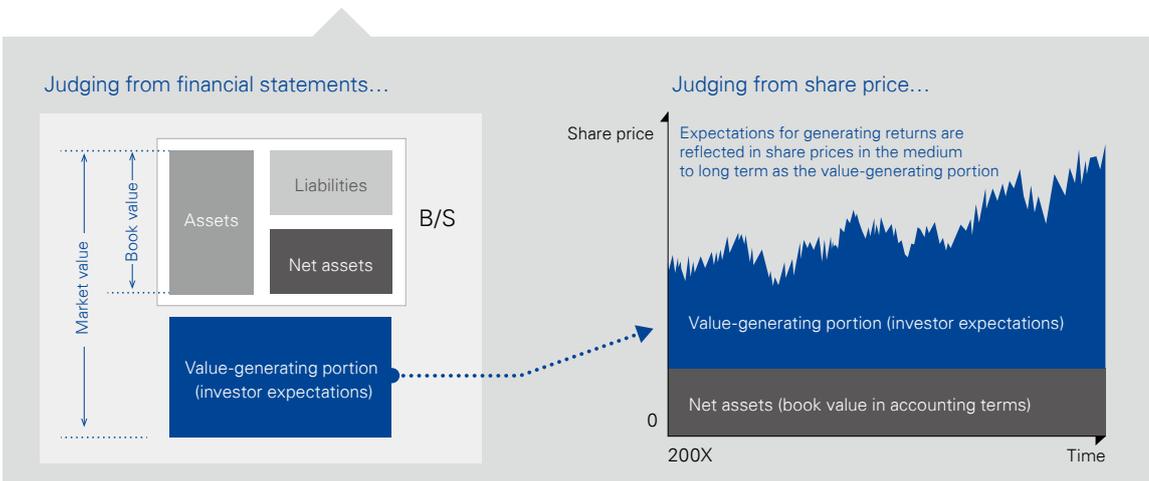
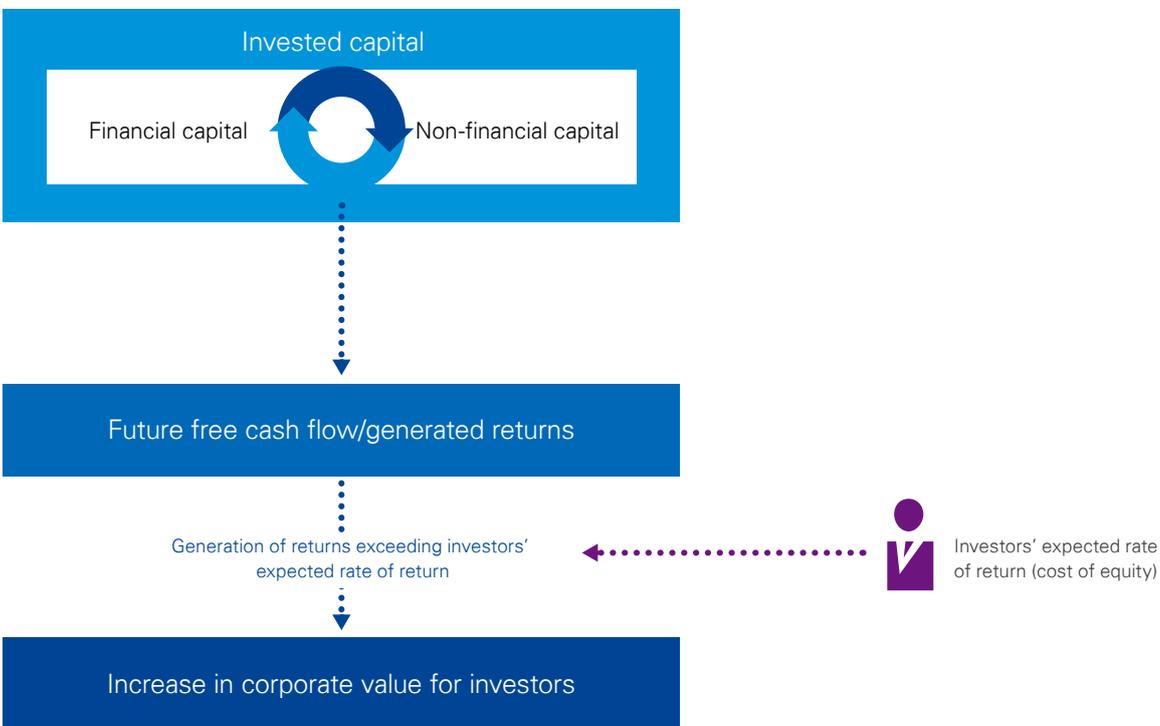
Governance to improve corporate value

Dialogue does not mean that companies pander to investors. Dialogue is an effort by companies and investors to improve corporate value through tension and collaboration. Investors' decision to supply growth capital (investment) comes when these dialogues reach fruition, and confidence in manage-

ment after investment is expressed by proxy voting at the shareholders' meeting.

In this sense, the board of directors plays a major role in the dialogue, and the foundation for improving corporate value is corporate governance. The way in which corporate governance is run is now in question.

■ Figure 19. Cost of equity and improving corporate value



2 — Approach to disclosure based on Corporate Governance Code

Disclosure in Corporate Governance Report

The Corporate Governance Code adopts the “comply or explain” concept, which requires that companies either comply with the principle or explain why if they do not. In a Corporate Governance report, the relevant items are disclosed in “I. Basic Concept of Corporate Governance and Capital Structure, Corporate Attributes and Other Basic Information.”

The 11 principles (Figure 20) requiring disclosure under the Code must also be noted in this section, and the six principles (Figure 21) requiring an explanation can also be noted here.

The Corporate Governance Code mandates that “disclosures should add value for investors, and the board should ensure that information is not boiler-plate or lacking in detail” (Supplementary Principles 3.1.1). As such, the board of directors should be actively involved in ensuring that the information provided is beneficial for users. However, many challenges in actual corporate governance reports have been pointed out, such as a lack of information on the quality of compliance, an inability to determine the extent to which the principles with which the company complies are actually being implemented, and a lack of specifics in the explanations for those principles that are not implemented, leading to a lack of credibility. Moreover, many reports fail to disclose information with the aim of showing how governance mechanisms and initiatives are raising corporate value, and as a result, they include many boiler-plate descriptions.

General Principle 3 of the Corporate Governance Code encourages the board of directors to take the following steps to provide a foundation for constructive dialogue with shareholders.

First paragraph of General Principle 3

Companies should appropriately make information disclosure in compliance with the relevant laws and regulations, but should also strive to actively provide information beyond that required by law. This includes both financial information, such as financial standing and operating results, and non-financial information, such as business strategies and business issues, risk and governance.

The information disclosed and provided should be accurate and easy for the user to understand, and should be very beneficial information.

Based on this intention, more companies are now establishing and disclosing their own guidelines and policies on corporate governance, separate from their corporate governance reports. These companies are not only disclosing information on the items for which “comply or explain” is required in the Corporate Governance Code, but also describing their corporate philosophy and their management stance on raising corporate value in the medium to long term, as well as their relationship with stakeholders. For investors interested in investing for the long term, this kind of disclosure is very useful in measuring the extent to which the corporate philosophy has spread in the company, for example. If initiatives related to improving disclosure based on the Corporate Governance Code further take off, approaches to constructive dialogue with investors and companies could become more fruitful.

Disclosure related to cross shareholdings

These boiler-plate phrases and descriptions lacking in detail are found in the aforementioned analysis and evaluation of the effectiveness of the board (Code Principle 4.11.3) and disclosure of the results, as well as disclosure of the policy on cross shareholdings and standards on the exercise of proxy voting rights (Principle 1.4).

Principle 1.4 Cross-Shareholdings

Principle 1.4 Cross-Shareholdings

When companies hold shares of other listed companies as cross-shareholdings, they should disclose their policy with respect to doing so. In addition, the board should examine the medium- to long-term economic rationale and future outlook of major cross-shareholdings on an annual basis, taking into consideration both associated risks and returns. The annual examination should result in the board’s detailed explanation of the objective and rationale behind cross-shareholdings. Companies should establish and disclose standards with respect to proxy voting rights as to their cross-shareholdings.

Looking at examples of actual disclosures, there are cases in which disclosure is abstract, such as stating that cross-shareholdings are held when it is determined that it would contribute to improved corporate value, taking into account the building, maintaining and strengthening of relationships with suppliers and business partners. In addition, there are also cases in which standards with substance are not provided for standards for the exercise of proxy voting rights. Many institutional investors are not expected to “comply or

explain” premised on the continuation of cross-shareholdings—rather, they generally do not accept the rationality of holding them in the first place.* The issues with cross shareholdings can be seen as one case of the disparity between the perception of capital efficiency on the part of companies and investors. There is a need to deepen the shared under-

standing by augmenting disclosure and engaging in dialogue between investors, including how to consider the significance of these holdings in terms of capital efficiency.

* Investor Forum Reports for First and Second Meetings, Appendix “Views on Cross-Shareholdings” (September 11, 2015)

Figure 20. Eleven Principles Requiring Disclosure in Corporate Governance Code

Principles	Items for disclosure
Principle 1.4	<ul style="list-style-type: none"> • Policy with respect to cross-shareholdings • Standards with respect to proxy voting rights as to their cross-shareholdings
Principle 1.7	<ul style="list-style-type: none"> • Framework for procedures in event of transactions between related parties
Principle 3.1	<ul style="list-style-type: none"> • Company objectives (e.g., business principles), business strategies and business plans • Basic views and guidelines on corporate governance based on each of the principles of the Code • Board policies and procedures in determining the remuneration of the senior management and directors • Board policies and procedures in the appointment of the senior management and the nomination of directors and Kansayaku candidates; and explanations with respect to the individual appointments and nominations
Supplementary Principle 4.1.1	<ul style="list-style-type: none"> • Scope and content of the matters delegated to the management
Second paragraph, Principle 4.8	<ul style="list-style-type: none"> • Roadmap for a company’s own decision to appoint at least one-third of its directors as independent directors
Principle 4.9	<ul style="list-style-type: none"> • Independence standards for independent directors established by boards
Supplementary Principle 4.11.1	<ul style="list-style-type: none"> • Balance between knowledge, experience and skills of the board as a whole, and also on diversity and appropriate board size (disclosed together with policies and procedures for nominating directors)
Supplementary Principle 4.11.2	<ul style="list-style-type: none"> • Status of concurrent posts as directors held by directors and Kansayaku at other companies (every year)
Supplementary Principle 4.11.3	<ul style="list-style-type: none"> • Analysis and evaluation of effectiveness of the board as a whole and a summary of the results
Supplementary Principle 4.14.2	<ul style="list-style-type: none"> • Training policy for directors and Kansayaku
Principle 5.1	<ul style="list-style-type: none"> • Policies concerning the measures and organizational structures aimed at promoting constructive dialogue with shareholders

Source: Prepared by KPMG based on the Corporate Governance Code

Figure 21. Six Principles for which Explanations are required in Corporate Governance Code

Principles	Items for disclosure
Principle 1.3	<ul style="list-style-type: none"> • Basic Strategy for Capital Policy
Principle 1.4	<ul style="list-style-type: none"> • Objective and rationale behind primary cross-shareholdings (every year)
Principle 1.5	<ul style="list-style-type: none"> • Adoption or implementation of anti-takeover measures
Principle 1.6	<ul style="list-style-type: none"> • Capital policy that may harm shareholder interests
Supplementary Principle 4.1.2	<ul style="list-style-type: none"> • Status of progress with medium-term business plans
Principle 5.2	<p>When establishing and disclosing business strategies and business plans,</p> <ul style="list-style-type: none"> • Companies should articulate their earnings plans and capital policy • Specific measures for the allocation of management resources to realize this

Source: Prepared by KPMG based on the Corporate Governance Code

V.

Recent developments in discussion relating to establishment of an environment conducive to dialogue

POINT

- » The key issue in disclosing corporate information that contributes to constructive dialogue is augmenting effective and efficient information disclosure that contributes to the evaluation of corporate value in the medium to long term.
- » Given that adequate time for dialogue is not secured in Japan's shareholder meeting process compared to other countries, more companies are promoting electronification to ensure time for dialogue. This is done by disclosing information on the company website ahead of the meeting and utilizing a platform for the exercise of voting rights, among other measures. The role that the dialogue-supporting industry plays in this process is gaining more attention, as well.
- » To ensure that the same amount of time is provided for dialogue as in other countries, it is vital that the schedule for the shareholder meeting be set appropriately—in other words, the record date for the shareholder meeting has to be made flexible, and the company, investors and dialogue-supporting industry would do well to work together to move the discussion forward.



1 — Disclosure of corporate information to promote constructive dialogue

In order to raise the company's ability to generate profits and increase corporate value on a sustainable basis, it is essential that the company and its investors/shareholders engage in constructive dialogues on the premise that their relationship is based on the creation of value for medium- to long-term growth. From this perspective, there are efforts underway to overhaul the system and procedures for corporate information disclosure and the shareholder meeting process, moving to a more comprehensive approach.

Japan's unique corporate information disclosure

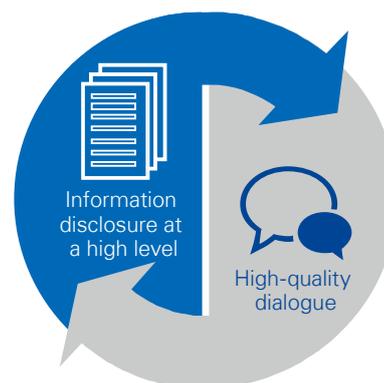
Corporate information disclosure has issues with overlap. In a problem distinct to Japan, companies are legally required to disclose information under a double set of regulations stipulated in the Companies Act and the Financial Instruments and Exchange Act, as well as timely disclosure that is required of listed companies when earnings reports are released. In other words, companies are asked to issue similar information for the fiscal year in subtly different forms on multiple occasions. This is not only a burden and wasteful repetition for the company producing this information, but the user also faces a burden in confirming the materials disclosed. In addition, the overlapping information might not be used appropriately. The company must produce multiple documents in a short period of time, and checking these documents also requires considerable time and energy. If we look at foreign disclosure systems, we find that Japan is the only country where three disclosure systems co-exist (Companies Act, the Financial Instruments and Exchange Act, and stock exchange regulations). This kind of triple disclosure system does not exist in the US and Europe (UK, Germany and France). Moreover, in Japan the Companies Act and the Financial Instruments and Exchange Act require auditing, respectively, while in the US and Europe (UK, Germany and France), audits are integrated under securities exchange laws or corporate laws.

Corporate information disclosure to improve the process of dialogue

At the same time, investors are augmenting the information needed to evaluate corporate value in the medium to long term and proposing the consideration of more effective disclosure methods. It is important to disclose the kind of information that can ensure a comprehensive understanding of the ways in which corporate vision, management policies, strategies and governance are linked to corporate results, financial conditions and the creation of sustainable value.

Keeping in mind the fundamental concept of corporate information disclosure, it is essential that an environment be established to ensure that disclosure leads to high-quality dialogue. It is necessary to assess the overall process of dialogue from the point of view that high-quality information disclosure raises the quality of dialogue, and high-quality dialogue encourages augmented information disclosure, in a reciprocal manner (Figure 22).

■ Figure 22. Relationship between information disclosure and dialogue



High-level information disclosure raises the quality of dialogue, and high-quality dialogue encourages augmentation of information disclosure (reciprocal effect, synergistic effect)

It is necessary to assess the overall process of dialogue

Source: Prepared by KPMG based on "Report on the Study Group concerning Promoting Dialogue between Companies and Investors for Sustainable Growth," METI (April 23, 2015)

Basic design concept for comprehensive disclosure

Based on these points, the Study Group concerning Promoting Dialogue between Companies and Investors for Sustainable Growth, initiated by METI, released its report in April 2015. This report recommended that mutual understanding be deepened through high-quality dialogue between companies and investors and that an environment conducive to creating medium- to long-term corporate value be established. Here, “dialogue” refers to the process based on a company’s information disclosure and ongoing exchanges with investors throughout the year, as well as feedback on information disclosure made through these measures. This definition takes into account a broad range of direct and indirect communication between companies and investors.

The report proposes measures enabling companies to provide disclosures in compliance with the Companies Act, the Financial Instruments and Exchange Act, and stock exchange regulations, as well as voluntary disclosures, with an integrated approach in order to give investors useful information more effectively and efficiently. The report lays out an approach called the “module-type disclosure system” as the basic architecture. The module-type disclosure system is an architecture for ascertaining the overall image of the information that needs to be disclosed (integrated and comprehensive corporate reporting overall) and then identifying the information

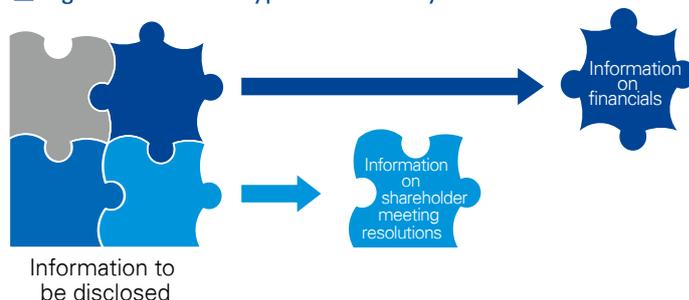
module (compiled materials) needed by investors and providing them at the most appropriate time (Figure 23).

Future of corporate information disclosure

The growth strategy adopted by the Cabinet in June 2016 embraces improved effectiveness and efficiency in corporate information disclosure as well as steady progress in digitizing the shareholder meeting process, as discussed below. This will serve as the foundation for supporting initiatives by listed companies to enhance the effectiveness of corporate governance.

In terms of promoting dialogue between companies and investors, the goal is to build on discussions thus far and establish an environment to ensure the most effective and efficient disclosure on an international basis as well as set rational schedules and record dates for the shareholder meeting by the first half of 2019.

■ Figure 23. Module-type disclosure system



Source: Prepared by KPMG based on “Report on the Study Group concerning Promoting Dialogue between Companies and Investors for Sustainable Growth,” METI (April 23, 2015)

[Column] Trends in voluntary disclosure: Increase in companies issuing integrated reports

In Japan, companies have voluntarily disclosed information in annual reports and CSR reports, but over the past few years, integrated reports have attracted more attention as a way of augmenting the information that investors need to evaluate corporate value in the medium to long term and a means of disclosing information more effectively.

In integrated reports, managers convey the company’s strategies, earnings targets and the course the organization is taking as a story of value creation, focusing on the organization’s strengths. This initiative is intended to contribute to the realization of concrete corporate value and a sustainable society by building better relationships with stakeholders and improving communication, with the business model as a foundation.

Integrated reports have attracted more attention because the discussion over the kind of information disclosure a company should provide took off when the collapse of Lehman Brothers spurred reflection on problems with short-

term investor behavior. In particular, the release of the International Integrated Reporting Framework in December 2013 by the International Integrated Reporting Council (IIRC), established in 2010, brought integrated reports into the spotlight. In Japan, in 2015 over 200 companies issued their own integrated reports, and even more companies are expected to issue integrated reports in 2016 now that the Corporate Governance Code is in place.

The IIRC sees these integrated reports as a separate disclosure media that can be used as an entry point to providing more detailed information. This approach has affinities to the architecture of the aforementioned module-type disclosure system. In the future, as discussions of the approach to corporate information disclosure in Japan go forward, a better understanding of the concept of integrated reporting and its popularization would play a key role in enabling constructive dialogue between managers and investors.

2 — Establishing an environment conducive to dialogue in the shareholder meeting process

The main issue with the shareholder meeting process in Japan is the concern that this process itself does not sufficiently contribute to dialogue. General shareholder meetings are forums in which the outcome of dialogue is revealed since shareholders grant their confidence to management at these meetings. However, foreign institutional investors in particular have pointed out problems in Japan's shareholder meeting process for many years.

Brevity of the dialogue and consideration of agenda for general shareholder meeting by shareholders

The main problems pointed out by institutional investors

are the negative effects caused by the concentration of general shareholder meetings. Compared to other countries, shareholders in Japan are not given adequate time to consider the meeting agenda and engage in dialogue. As shown in Figure 24, there is an average of 21 days between the time convocation notices are issued and the general shareholder meeting, while the duration in other countries is about twice as long. Moreover, the duration for dialogue broadly defined as the period from the financial settlement date to the shareholder meeting date is 85 days in Japan, but 140 days in foreign countries. In addition, the duration from the record date for the exercise of voting rights to the general shareholder meeting was the longest in Japan at 85 days, and about one week in the UK, Germany and France. This indicates that the time available for investors to consider the agenda for the share-

■ Figure 24. Duration for dialogue in foreign countries

① Duration from notice of convocation or announcement to general shareholder meeting

	Japan	US	UK	Germany	France
10 large-scale companies	21.1 days	43.0days	41.6days	45.3days	48.6days
10 medium-scale companies	—	42.4days	44.1days	39.8days	41.4days
10 small-scale companies	—	40.8days	35.4days	41.2days	37.1days
Average	21.1days 0.68months	42.1days 1.36months	40.4days 1.30months	42.1days 1.36months	42.4days 1.37months

② Duration from financial settlement date to general shareholder meeting in different countries

	Japan	US	UK	Germany	France
10 large-scale companies	85.0days	124.4days	119.4days	122.1days	122.7days
10 medium-scale companies	—	138.3days	130.7days	169.6days	150.0days
10 small-scale companies	—	144.1days	161.2days	162.2days	154.0days
Average	85.0days 2.8months	135.6days 4.5months	137.1days 4.6months	151.3days 5.0months	142.2days 4.7months

③ Duration from record date for exercise of voting rights (deadline for registering with company) to general shareholder meeting

	Japan	US	UK	Germany	France
10 large-scale companies	85.0days	57.4days	2.5days	6.7days	4.5days
10 medium-scale companies	—	56.7days	1.9days	11.2days	4.6days
10 small-scale companies	—	52.9days	2.3days	8.4days	4.2days
Average	85.0days 2.8months	55.7days 1.9months	2.2days 0.07months	8.8days 0.29months	4.4days 0.15months

Source: METI's "Study Group on Promoting Electronification of Processes for Shareholder Meetings" (April 4, 2016) (hereafter, "Electronification Study Group Report"), page 24, "Status of Electronification of Shareholder Meeting Process in Japan and Foreign Countries"

holder meeting in Japan is short compared to foreign countries. Effectively, foreign investors normally have only one to three business days to consider the agenda (if the notice of convocation is sent two weeks before the meeting, as legally stipulated). This is because shares owned by institutional investors are held in custody by custodians, and the agenda is acquired via local custodians or custodians. Instructions for exercising voting rights are also provided via these institutions, and in addition local custodians and issuing companies primarily exchange information on a paper basis, such as exercise of voting rights. The requisite number of days must be set aside, and this reduces the time available for institutional investors to consider the agenda.

Not only is there inadequate time to consider the agenda and engage in dialogues, but the period of time between the record date for the exercise of voting rights and the shareholder meeting is quite long. As a result, there is a higher risk in Japan than in other countries of “empty voting” in which shareholders who sell after the record date exercise their voting right at the shareholder meeting. The government is leading a wide range of deliberations to overhaul the shareholder meeting process in Japan and attempt to secure time for dialogue on par with foreign countries. Japan’s shareholder meeting process is nearing a turning point, as indicated by an expansion in the time available to institutional investors to consider the agenda, the approach to providing shareholder meeting information and electronic voting opportunities to individuals, and setting an appropriate schedule for the general shareholder meeting.

Early disclosure on websites

Initiatives to post the convocation notice on the website before it is mailed to shareholders have been discussed several times in the past, and the Supplementary Principle 1.2.2 in “Principle 1.2 Exercising Votes in the General Shareholder Meetings” in the Corporate Governance Code states the following:

Supplementary Principle 1.2.2

While ensuring the accuracy of content, companies should strive to send convening notices for general shareholder meetings early enough to give shareholders sufficient time to consider the agenda. During the period between the board approval of convening the general shareholder meeting and sending the convening notice, information included in the convening notice should be disclosed by electronic means such as through TDnet or on the company’s website.

Early disclosure on the web is the easiest task for companies to undertake in the current shareholder meeting process. By posting information on TDnet, the same information gets posted on the securities exchange’s website, “Arrow Force,” a website dedicated to providing institutional investors with convocation notices, and electronic voting platforms. In this way, companies will be able to notify institutional investors earlier. Disclosing notices early on the website using TDnet means that institutional investors have an additional four business days to consider the agenda.

As shown in [Figure 25](#), in 2015, the first year in which the Corporate Governance Code was introduced, 769 listed companies with shareholder meetings in June disclosed notices early on websites. The number of companies planning to disclose early in 2016 nearly doubled over 2015 levels to 1,508 companies.

■ **Figure 25. Companies disclosing notices early on websites**

	2013	2014	2015	2016*
Companies disclosing early on website	47	91	769	1,508
Overall	1,628	2,359	2,532	1,956
Percentage	2.9%	3.9%	30.4%	77.1%

* Only general meetings held in June are included in total for 2016. Figures are compiled using the planned date for the mailing of the convocation notice for companies whose fiscal year ends in March and the planned date for release on securities exchange websites (as of May 30, 2016). The Electronification Study Group Report was used as reference for figures for 2013-2015 and prepared by KPMG.

Electronification of the entire voting process

Electronification of the voting process is addressed in terms of both providing convocation notices and the exercise of voting rights.

The US and UK, among other countries, have systems to provide electronic access to notices of convocation and other documents, and about 80% of individual shareholders receive such notices electronically.

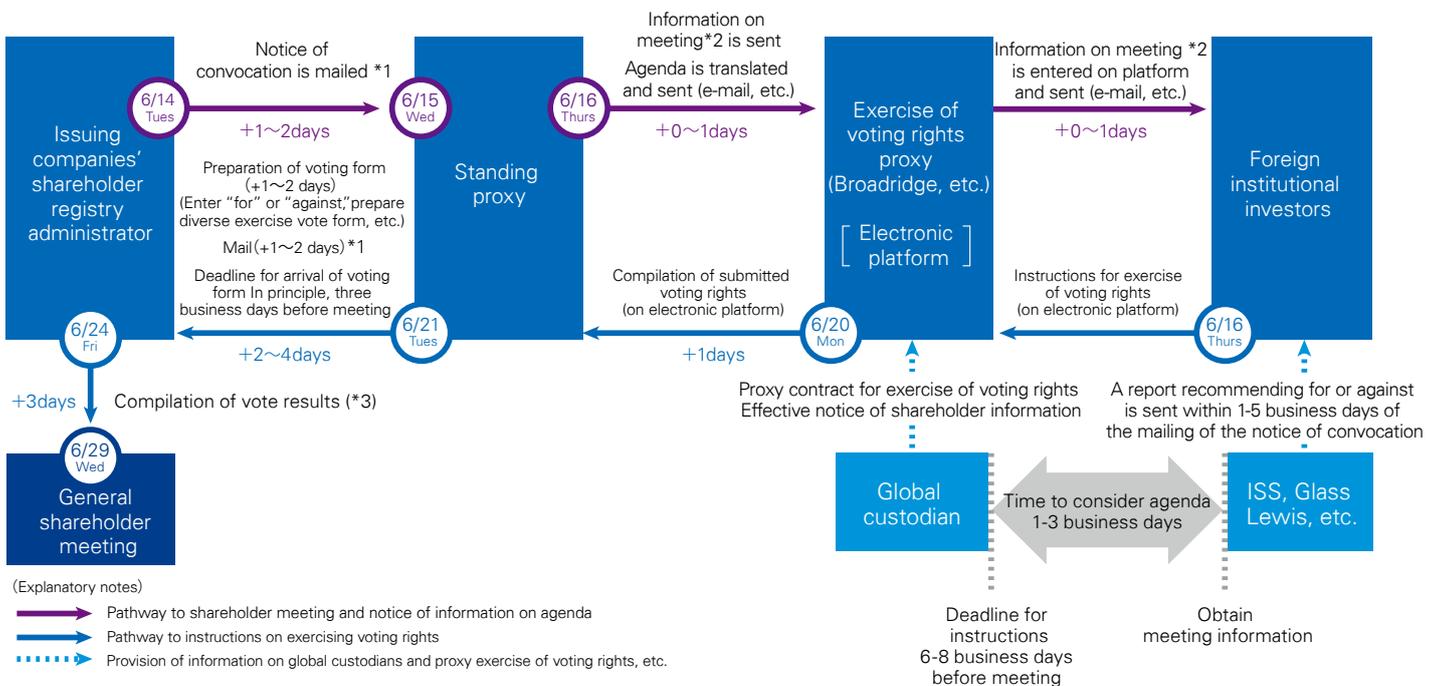
For example, the US has the Notice & Access system. Proxy statements for the shareholder meeting and annual reports for shareholders are posted on the website, and the shareholder is only mailed a notice with the relevant address on

the website, time, date and location of the meeting, and the meeting agenda etc. This method is called the "Notice Only Option." Moreover, listed companies can, as before, mail shareholders the notice of convocation, proxy statement and annual reports for shareholders (Full Set Delivery Option). In the UK, shareholders are mailed a notice of agreement concerning the posting of notices of convocation on the website, and if there is no response within 28 days, shareholders are deemed to have given their permission for this form of communication. Japan also has an electronic access system, but it is premised on individual authorization by shareholders, and companies have to deal with requests from shareholders to mail paper notices, so the penetration rate is not high. The percentage of Japanese companies using the electronic access system is only 2.6%, according to a questionnaire given to 2,502 companies reported in the 2015 White Paper on Shareholders' Meetings (68.1% response rate). Moreover, it is estimated that only 0.03% of individual shareholders receive notices of convocation electronically.*

* METI's Study Group on Promoting Electrification of Processes for Shareholder Meetings (April 21, 2016), page 90

Given these conditions, METI released the "Proposal for Establishing a New System for Electronic Provision of Materials." These recommendations were incorporated in Japan's Revitalization Strategy in 2016. The proposal refers to four common points shared by electronic access systems in other countries, namely: "(1) all information legally required and information that should be provided before the shareholder meeting is disclosed on the Internet, (2) the minimum amount of information required, such as the Web address, is sent to shareholders on paper, (3) companies do not need individual authorization from shareholders when adopting this system and (4) shareholders who want to receive all information on paper must request this of the company. However, in light of the environment for Japan's shareholder meetings and companies' practical affairs, the specific legal measures will be considered with a focus on starting to establish the corporate legal framework for this early next year." At the same time, it is recommended that companies and institutional investors participate in the electronic voting

Figure 26. Voting rights overseas (before electrification)
 Notice of convocation issued on June 14, 2016 (Tuesday) in case in which shareholder meeting is held on June 29 (Wednesday)



*1. The mailing time is different depending on whether it is mailed in the morning or afternoon, where it is mailed to, and the weather. In the above flow diagram, for convenience the outward mailing is estimated at one day between the shareholder registrar and the local custodian and two days for the return mailing. Mail is collected on Saturday as well, but this flow diagram is based on business days.

*2. Meeting information sent in this case is the company name, date and location of meeting, deadline for submitting instructions and record date. The notice of convocation (translation) and reference documents are sent by the local custodian at the request of the global custodian or foreign institutional investor.

*3. The shareholder registrar compiles the voting results for institutional investors on the day that the vote form arrives and, together with the results for individual shareholders (typically, shareholders can vote up until the evening on the day before the meeting), reports the compiled results every day to the issuing company until the day before the meeting.

Source: Prepared by KPMG based on Electrification Study Group Report, page 43, and interviews with those involved.

platform. By doing so, companies can extend the time available for foreign institutional investors to consider the agenda to 10-11 days (in the event that the notice of convocation is sent, as legally required, two weeks before the shareholder meeting).

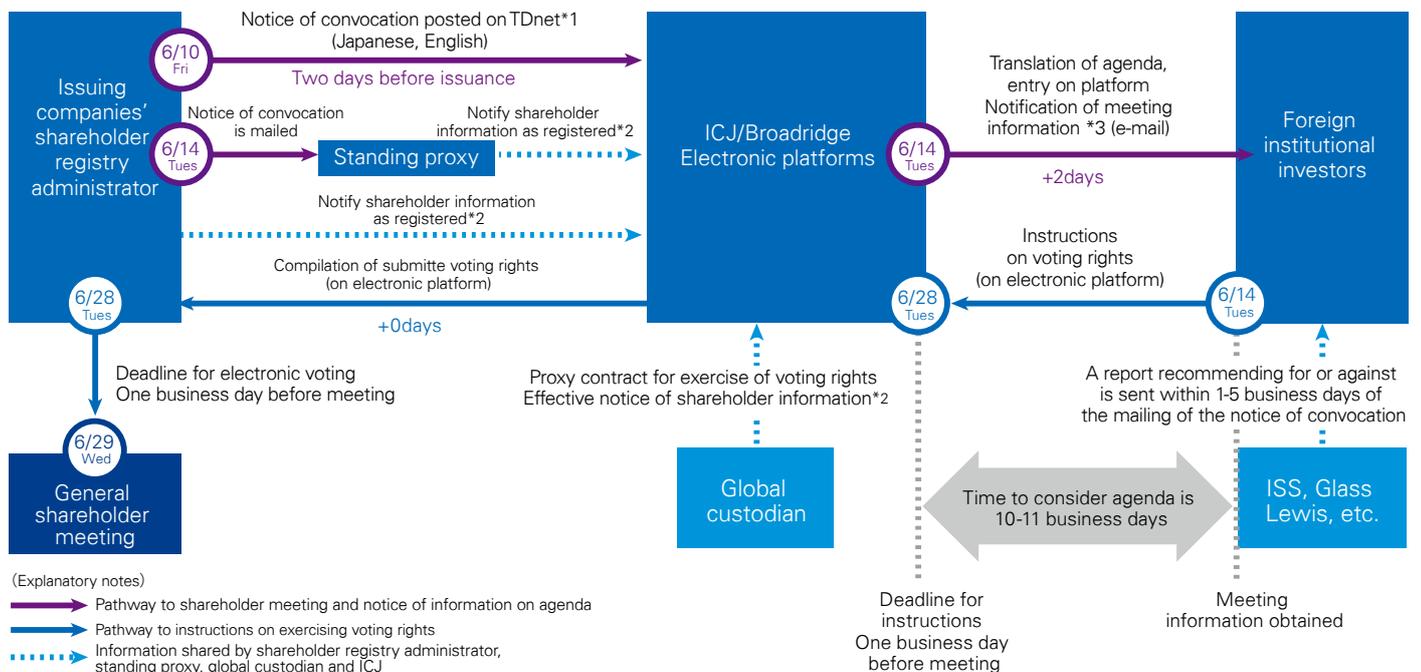
By participating in the electronic voting platform, Japanese institutional investors can also ensure that they have the same amount of time to consider the agenda as foreign institutional investors. This platform makes it possible to resend the instructions up until the day before the shareholder meeting. This will allow institutional investors to resend their instructions as an outcome of dialogues, providing merit for the participating companies. In part due to the adoption of the Corporate Governance Code, the number of companies using the electronic voting platform is increasing dramatically. In Japan, ICJ Co., Ltd. provides the electronic voting platform, and as of May 30, 2016, 755 companies had announced their intention to participate. In just about one year, over 200 com-

panies newly announced their intention to participate. As the number of participating companies increases, the number of institutional investors (particularly foreign institutional investors) enjoying the merits of a more extended period of time to consider the agenda is expected to increase.

Setting appropriate schedule for general shareholder meeting

General shareholder meetings tend to take place in June in Japan. This is because the record date for exercising voting rights and the final day of the fiscal year is the same for Japanese companies, and the Companies Act requires that general shareholder meetings be held within three months of the record date for exercising voting rights. However, there is no rule under the current Companies Act that requires that the general shareholder meeting be held within three months of the last day of the fiscal year. In other words, general shareholder meetings tend to be held in June so that, for practical reasons, the record date for exercising

■ Figure 27. Voting rights overseas (after electronicfication)
 Notice of convocation issued on June 14, 2016 (Tuesday) in case in which shareholder meeting is held on June 29 (Wednesday)



*1. TDnet stands for Timely Disclosure network and is a system run by the Tokyo Stock Exchange that provides disclosure information in a timely manner. English versions of the notice of convocation are voluntarily registered only when made available.
 *2. After the record date for the shareholder meeting, ICJ obtains shareholder information (primarily information on the number of shares) via the system from the administrator of shareholder registrars, the local custodians and the global custodian (via Broadridge), and then confirms whether this is consistent with data on the shareholders of record and actual shareholders and makes adjustments.
 *3. Meeting information refers to the company name, date and location of meeting, deadline for submitting instructions and record date. The notice of convocation (translation as well if a translation is available) is posted on the electronic platform.
 Source: Prepared by KPMG based on Electronification Study Group Report, page 43, and interviews with those involved.

voting rights and the final day of the fiscal year are aligned. While it is true that early web disclosure and the electrification of the overall voting process has the effect of extending the time available to consider the agenda, the record date for exercising voting rights should be set on a day other than the fiscal settlement date if the goal is to ensure time to consider agendas commensurate with other countries. For example, general shareholder meetings should be scheduled for July. In this case, the record date for exercising voting rights would be set at the end of April, and if the notice of convocation is sent out in late May to early June as it currently is, shareholders would have about two months to consider the agenda. There are many practical issues that would have to be considered to achieve this. At present, Kabukon (All Japan Federation of Stock Associations) is summarizing the issues when the record date for exercising voting rights is set on dates other than the fiscal settlement date, and going forward we can expect companies to consider appropriate dates for their general shareholder meetings.

Expectations for dialogue-supporting industry

As these initiatives are expected to lead to changes in the approach to dialogue between companies and shareholders, the dialogue-supporting industry also plays an important role in the shareholder meeting process.

With the spread of electronic access to convocation notices and electronic voting in other countries, the dialogue-supporting industry provides a wide range of services. For example, in the US there are companies engaged in initiatives such as building platforms that allow individual shareholders to view convocation notices and exercise voting rights for all the companies in which they hold shares, and combining shareholder meeting information with not only PDF materials, but also a video of the president's message. In Japan, when individual shareholders try to exercise their vote electronically, they must go through a rather complicated process first, such as entering their ID and password separately every time.

In Japan, the dialogue-supporting industry is expected to make progress in building an integrated platform and to consider use of the "My Number" personal ID system. Those involved in the dialogue-supporting industry are expected to consider the practical tasks involved in setting the schedule for the shareholder meeting, and expectations for this industry are rising.

Approach to dialogue in the shareholder meeting process

Japan's shareholder meeting process has developed over a long period. However, this progress has only been made within the existing framework, and a comparison with other countries clearly shows that it has been inadequate in terms of dialogue.

Establishing a new electronic access system, promoting early web disclosure, promoting electrification of the voting process overall and setting up an integrated platform would improve the efficiency of the dialogue measures in the shareholder process, and is essential in promoting dialogue.

At the same time, these initiatives are not fundamental solutions in terms of securing adequate time to consider agendas. The schedule related to shareholder meetings has to be set appropriately if the time for dialogue is to be on par with other countries, and this means that the record date for the shareholder meeting must be flexible. Companies, investors and the dialogue-supporting industry would do well to work together to identify the practical issues involved and then move ahead to solve them.

The Cabinet decided on the electrification of the shareholder meeting process as part of Japan's Revitalization Strategy, and the government will lead a review of the specific measures, including legislation. In addition, a follow-up meeting, including the dialogue-supporting industry, is to be held. Japan's shareholder meeting process is expected to develop on par with other countries going forward.

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KPMG Japan's Corporate Governance Center of Excellence (CoE) was formed with the aim of studying, analyzing and providing information on corporate governance trends in Japan.

KPMG Japan's Corporate Governance CoE comprises KPMG Japan's experts on the Companies Act, boards of directors and risk management, dialogue with investors (engagement), integrated reporting, information disclosure and shareholder meetings. The organization compiles knowledge and best practices related to corporate governance by utilizing KPMG's global network and affiliated external institutions, and gives advice.

The Corporate Governance CoE will continue to provide information on the latest trends in corporate governance by holding seminars and issuing reports, among other endeavors.



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