

Provisional Translation

Executive Summary
- About the Revised CGS Guidelines -

July 19, 2022



1. Background to the Revision

- The "earning power" of Japanese companies overall is sluggish, and investment in medium- to long-term growth, including in intangible assets such as R&D and human capital, is not necessarily increasing. The appraisals Japanese companies get from the capital markets are tough, and their "corporate value" as expressed by the stock price indices is currently falling behind that of those in Europe, the United States, and emerging countries, with around 40% of Japan's leading companies (TOPIX 500) having a PBR of less than 1.
- While deep-rooted problems such as population decline and lack of urgency in changing the industrial structure lay behind this, Japanese companies are currently facing more crucial issues—namely, major environmental changes such as the shift to a carbon neutral society, a rapidly digitalizing society, geopolitical changes, and diversity and inclusion.
- Ideally, the public and private sectors should progressively address these socio-economic issues together, based on a shared, long-term vision. The following are now more desirable than ever in order to achieve this: that managers must be able to engage in entrepreneurship and follow their instincts in sound ways, leading to better management strategies and an environment which enables rapid risk taking; and listed companies must be made aware of the need to increase their corporate value, and their mere survival should not be regarded as the top priority.
- From such a viewpoint, many companies have been working on measures such as invigoration of their boards of directors, and there are some opinions that it has led to improved management capability. On the other hand, some feel that corporate governance reforms have yet to go far enough to encourage more active risk-taking, or greater investment to contribute to medium- to long-term corporate value.
- In light of these opinions and assessments, CGS Guidelines offer recommendations based on the view that corporate governance reforms will support the resolve and efforts of companies.

CGS
Guidelines
1.1.

2. Directions Pursued in Revising the Guidelines

■ **Strengthening executive functions and improving medium- to long-term corporate value through governance reforms**

1.2.

- Corporate governance reforms have generally been pursued under the banner of achieving "growth-oriented governance," and the following are examples of ways they can contribute to sustainable growth and improving medium- to long-term corporate value:
 - (1) Improve medium- to long-term corporate value by strengthening top management through measures such as nominating outstanding people to be the president/CEO.
 - (2) Improve medium- to long-term corporate value by ensuring that the management decision-making processes are rational, and thereby encourage top management to make bold decisions.
 - (3) Improve medium- to long-term corporate value by having the board of directors review strategies developed by top management (which form the core of management decisions), and thereby allocating resources appropriately.
 - (4) Improve medium- to long-term corporate value by improving management through the appraisals from the markets and dialog with investors.
- The personnel who play the central role in improving a company's medium- to long-term corporate value—and are centrally responsible for how it is managed—are its president/CEO and other top management executives. A key question therefore is what kind of governance systems to create for them.
- In particular, it is important that a company's board of directors—the keystone to its governance—be made to function effectively in order to select outstanding people to be its top managers, and that the board of directors encourage its top executives to be strongly aware of the need to increase its corporate value, through activities such as reforming its culture, making long-term investments that involve taking risks, and reviewing its business portfolio.
- In addition, the trend toward having more outside directors means that unless their attitudes and awareness change, governance reforms will not result in any substantial change. Changing the awareness of outside

directors and improving their quality is therefore more important now than ever before.

- In the process of formulating management strategies and establishing governance systems, a company's executives and board of directors will change as they influence each other. In order to enhance their corporate value by improving their governance systems, companies must therefore consciously work to strengthen both their executive functions and monitoring functions synergistically, and not simply to strengthen their monitoring ones alone.

■ Approach taken by CGS Guidelines

- The kind of governance chosen and how it is made use of in management are key components in a company's competitive strategy, and are also aspects that shareholders base their evaluations on. What companies should do to solve their corporate governance issues will depend on their individual situations, so the measures CGS Guidelines recommend are not intended to be applied uniformly by all.
- Companies should renew their awareness of the fact that the Corporate Governance Code adopts a "principle-based approach" and a "comply or explain" methodology, and that CGS Guidelines are also based on these frameworks.
- In promoting efforts toward corporate governance, companies are strongly expected to first understand the intentions and spirit of each principle. Then, they should autonomously devise approaches based on what they aim to achieve (e.g., in terms of their management philosophy and strategies) and on characteristics such as the nature and scale of their business, and also actively explain the reasons for their choices to their shareholders and other stakeholders.

1.3.

3. Improving the Roles and Functions of Boards of Directors

■ Meaning of "monitoring"

2.1.

Recently corporate governance reforms have emphasized strengthening the monitoring functions centered on the board of directors. However, the meaning of "monitoring" could be misunderstood, and there has also been a considerable increase in the number of outside directors. In light of these situations, the revised CGS Guidelines have updated how the meaning of "monitoring" is presented.

- As the number of outside directors increases and the scope for which the board of directors can make specific decisions regarding the execution of individual business actions is limited, then the core of the "monitoring" expected of the board of directors will consist of evaluating performance and judging the propriety of management activities through nomination and compensation decisions, in light of the basic management policies and strategies formulated by top management and approved by the board of directors themselves.
- The "monitoring" required of the board of directors does not simply consist of things like reining in executive decisions and uncovering misconduct themselves. It also includes encouraging appropriate risks to be taken and internal management reforms to be made, and drawing attention to the risk posed by not taking risks (i.e., the risk of inaction).
- The board of directors must also be aware of how the capital markets view the company, and understand how favorably its corporate value is rated by the market. When outside directors perform monitoring functions, it is important to also keep in mind whether the shareholders and other stakeholders will benefit.
- When a company has a significant number of outside directors, it will inevitably have to transform its board of directors from the traditional model into something new. When such a board of directors meets to discuss matters, it will be beneficial if it is aware of the following perspectives: it should check whether matters can be appropriately explained to the shareholders and other stakeholders, and offer advice that is based on expertise and experience. Also, if shareholders have made suggestions about the management of the company, it should either persuasively urge

top management to give them serious consideration, or persuasively support top management as it responds to the concerned shareholders.

■ **Governance systems that emphasize the monitoring functions**

2.3. / 2.4.

The revised CGS Guidelines have updated the thought regarding the choice of a governance system and an appropriate organizational design for it. This has been done in light of the following facts: monitoring functions are progressively being strengthened (as exemplified by the increase in outside directors) and the number of companies changing their organizational designs is also on the rise; and it is important that governance makes it easier for top management to take risks, while also increasing the speed at which the company is managed.

- Boards of directors are typically broadly divided into two models: (A) one oriented toward having the board of directors specialize in monitoring; and (B) one oriented toward strengthening the monitoring both within and outside the board of directors while emphasizing its decision-making functions.
- With either model, there is expected to be strong awareness of the role the board of directors plays in improving corporate value by establishing basic management policies and strengthening the monitoring functions, which in turn encourages top management to take appropriate risks and effect internal management reforms.
- Governance systems based on (A), which emphasizes the monitoring functions, are beneficial in the following ways:
 - Executives are given broad discretion through delegation of authority—always on the premise that they will be prevented from engaging in runaway or depraved conduct—and this in turn clarifies their authority and responsibilities and encourages them to take risks soundly.
 - Since the monitoring by the board of directors is conducted through appointment, dismissal, and compensation decisions based mainly on performance evaluations, top managers are motivated to take risks so that they will be rated more highly.
 - If a company has tended to prioritize an organizational logic based on internal consortia and focus on maintaining its organizations and increasing sales, but then seeks to shift its management focus toward increasing its profit margin and efficiently allocating its management resources, then its internal logic will be reconsidered through having objective evaluations by outsiders to compare it with.
- With governance systems based on (B), which emphasizes the board of

directors' decision-making functions, the board of directors is involved in the decision-making on the execution of individual business actions. Consequently, if the proportion or number of outside directors is increased, then operational measures must be devised to ensure that the speed of decision-making is not compromised.

- What kind of governance system to choose and how to make use of governance in management are core elements of companies' competitive strategies, and they should make such decisions independently. That said, depending on their situation, it is beneficial to consider shifting to a governance system that emphasize the monitoring functions.
- Companies should ideally make choices regarding which governance system to adopt and which organizational design is appropriate for it, and ensure they can explain the reasons for them to the shareholders and other stakeholders.

■ Matters to consider when becoming a Company with an Audit and Supervisory Committee (*Kansa-tou linkai Setchi Kaisha*)

2.4.3. /

Appx. 2

In light of the increasing trend toward evolving into a Company with an Audit and Supervisory Committee (*Kansa-tou linkai Setchi Kaisha*) in order to have more outside directors, the revised CGS Guidelines have organized the important matters to consider in order for the change in company type to be effective.

- It is important that companies review the roles and functions of their boards of directors, given the fact that what is required for the board of directors will change due to the need to execute business swiftly and take risks, and due to having more outside directors. Companies should thoroughly consider largely delegating to their executives the task of making specific decisions on the execution of individual business actions, and have their board of directors specialize in monitoring.
- In order to avoid any unnecessary conflict, one possible relationship to have between the audit and supervisory committee's authority to state opinions (*Iken Chinjutsu Ken*) and any of the non-statutory nomination and compensation committees is as follows: the former committee forms its opinions in light of the decisions reached by each of the latter committees, having checked them with the main focus on whether the latter committees' decision-making procedures are appropriate.
- In order to improve the effectiveness of their audits, it is important that companies conduct audits mainly via their internal control systems, and then

strengthen their internal audit divisions themselves, and the coordination between those divisions and the audit and supervisory committee. (These are also effective measures for Companies with Auditors (*Kansayaku Setchi Kaisha*) and Companies with a Nomination Committee, Etc. (*Shimei linkaitou Setchi Kaisha*))

■ **Criteria for discussing dismissing or not reappointing the president/CEO**

4.1.5.

- Discussing dismissing or not reappointing the president/CEO will be more effective if the company first clarifies its ideal image of what its president/CEO should be, then organizes its thinking on the circumstances under which doing so should be proposed and discussed. A beneficial measure for achieving this is to consider establishing—before any need for them arises—criteria (in some cases, quantitative ones) for the board of directors or nomination committees to initiate discussions on whether to dismiss or not reappoint the president/CEO.
- It is beneficial to ensure transparency by disseminating information on the processes for succession planning and nominating successors and, if there are nomination committees, information on the basic policies regarding matters such as how the nomination committees that supervise these processes are involved. However, since these are sensitive matters, an appropriate approach is to externally disclose information on individual aspects only to an extent that will not cause problems.

4.1.2.

■ **Nominating directors based on the company's issues**

2.5.2. /

- It is beneficial for the board of directors to nominate people who have the knowledge, experience, and abilities the company requires given the issues it faces, taking into account an appropriate board size.
- In particular, important issues for many Japanese companies are the need to increase their mutual understanding with the capital markets and shift their management focus toward emphasizing efficiently allocating management resources. Therefore, in addition to deepening their CEO's and CFO's understanding of the capital markets and having their top management and outside directors dialog with investors, one possible option is to select outside directors who have sufficient knowledge, experience, and abilities regarding capital market-aware management.
- There are examples wherein the board of directors nominates "people

Appx. 3

related to investor shareholders" to be directors, with the aim of strengthening the systems by which it monitors the formulation and implementation of strategies by top management. In such cases, due care must be taken regarding matters such as conflicts of interest, information control, independence, externality, and disclosure.

4. Quality and Evaluation of Outside Directors

■ Quality of outside directors

- It is important that the outside directors include people who will act responsibly if involved in appointing or dismissing the president/CEO, and take the lead in such matters if necessary.
- In addition to monitoring affairs via the board of directors, outside directors are also expected to actively seek out information, and besides that, diligently pursue self-improvement through training and other means. This is so that they can add value to the board of directors' discussions by bringing to them a wide range of perspectives and insights that internal personnel alone could not.
- Companies should provide and arrange training opportunities for outside directors that suit their individual needs, and support them with the costs.

■ Nomination and compensation committees' members and chairpersons

- For a non-statutory nomination or compensation committee, it should be considered to appoint outside directors for the majority of the members and for their chairpersons.

■ Evaluation of outside directors

- One possible approach to evaluating outside directors is for the chairpersons of the board and chairpersons of the nomination committees (who are outside directors), the lead independent directors, and other suitable personnel to lead evaluation activities, including self- and mutual evaluations by the outside directors themselves.
- Interviews for mutual evaluations (not final evaluations or judgments) should ideally be conducted by the chairpersons of the board and chairpersons of the nomination committees (who are outside directors), the lead independent directors, and other suitable personnel, and also third-party organizations. The opinions of the president/CEO and other executives can also be included as a part of mutual evaluations, so as to cover even more perspectives.
- When disseminating information, it is not appropriate to publish the actual details of the evaluations, but only the fact that an evaluation has been

3.2. / 3.3.

Supplement
to CGS
Guidelines
Part 1

Appx. 1
Step 8

conducted and the processes involved.

■ **Board succession**

- One possible approach is to discuss measures (board succession) to create a situation in which the board of directors can autonomously and continuously fulfill its monitoring functions.
- The following are important to ensuring that board succession is discussed meaningfully: the board of directors and nomination committees work together; if the nomination committees have any part in the matter, then they meet more frequently; and trust is built between the people involved (e.g., the chairpersons of the board, chairpersons of nomination committees, president/CEO, and secretariat).

Appx. 1

Step 9

5. Creating an Environment for Strengthening Management Leadership

■ Importance of strengthening the executive functions

5.1.

- A company's president/CEO plays a central role in steering how it is managed, ensuring that it grows sustainably, and improving its medium- to long-term corporate value.
- The success of bold management reforms depends mostly on the "top management power," i.e., top management's ability to lead effectively.
- A prerequisite for selecting a president /CEO who can take risks and make unconstrained management decisions is that the nomination system for doing so be functioning properly.
- The following are examples of beneficial measures for having a president/CEO with these qualities lead effectively, and thereby creating internal systems for promoting management reforms, and achieving "growth-oriented governance."
 - The president/CEO personally establishes a top management team led by him/herself, clarifies the members' responsibilities and authority, then delegates authority to them.
 - Create systems so that when leadership is required, management strategies will be formulated and executed under the direct control of the president/CEO.
 - Presidents/CEOs are currently appointed later in life than overseas, so ensure that the company's president/CEO will be able to vigorously pursue the management strategies for an adequate period of time by appointing younger candidates to the position, and not replacing them with a successor after a few years based on seniority.
 - Strengthen the incentives for the president/CEO and the rest of top management.
 - Develop personnel with executive potential to support the next generation of presidents/CEOs.
 - Clarify the roles of retired presidents/CEOs to prevent them from exercising unjustifiable influence.

■ Composition of the top management team and authority

5.2.

delegated to it

- An effective approach for executing business more swiftly and enabling more appropriate management decisions to be made is as follows: clarify the responsibilities and authority of each executive officer in the top management team led by the president/CEO, then delegate authority to them accordingly. When doing this, another effective measure to take while clarifying the responsibilities and authority is to establish a chief executive officer (CXO) for each function.
- To ensure that the top management team creates innovation, it is important to make sure that it too has adequate diversity. Information about their diversity should ideally be actively disclosed.

■ Devising ways to formulate and execute strategies and other measures

5.3.

- In order to increase its corporate value, a company must be more aware of the basic principle that listed companies' corporate value is rated in the capital markets, and come up with strategies to improve its capital efficiency and develop new areas of business. It is also important when doing so that both the board of directors and executives consider the following issues:
 - Seriously discuss the use of internal reserves. Also, review whether the cash and deposits are at a desirable level for the management strategies and business operations.
 - Be aware that management means consciously thinking about indicators related to the management strategies, also taking into account the outside directors' opinions without prejudice.
 - Develop strategies toward investing in and utilizing human capital, R&D, and other intangible assets that will generate a competitive advantage.
 - Continuously review the business portfolio, and optimize it to keep pace with the changing management environment.

■ Using committees to strengthen the managerial and executive functions

5.4.

- One possible option for strengthening the managerial and executive functions is as follows: establish committees to consider and promote specific themes such as strategies and sustainability company-wide, based on the commitments of the president/CEO.
- Committees like these are often established with the intention of

strengthening the executive functions, and in such cases, their members will usually mostly be internal personnel. Also, even if they are established with the intention of strengthening the executive functions, having the committees report directly to the board of directors will be beneficial in terms of providing the board with study results from the committees, for example.

- On the other hand, the committees that companies establish to enhance and complement their boards of directors' functions are set up in a variety of contexts, and details such as how to choose the members will conceivably vary depending on the situation and purpose they are intended for.

■ Top management's compensation

4.2.

- It is important to adopt the following sequential, narrative approach: first establish management indicators (KPIs) to serve as specific targets based on the management strategies, then consider what kind of reward system would be good for achieving those targets.
- If non-financial indicators are to be used, then the board of directors and compensation committee should thoroughly discuss them based on the management strategies and plans, then clearly define the indicators and quantitative targets that will be used. Also, information such as the reasons for selecting them should also be disclosed with high transparency.
- In order to clearly show their commitment to achieving their performance targets and their shareholder-conscious attitude to management, global companies may conceivably choose to increase the proportion of performance-linked compensation to the same level as their global benchmark companies, or choose to make the proportion of long-term incentive compensation the same as the global level of around 40 to 50%.

■ Developing personnel with executive potential and improving their engagement

5.5.

- It is important to create a pool of executive candidates and consciously work on developing them. Granting shares in the company as compensation and making use of the shareholding association are beneficial ways to motivate executive candidates and it will also help increase investment in their human capital.