The GR Scores 2020 and The Governance Status of the 111 Companies with the GR Scores

NIKKO RESEARCH CENTER

Introduction

Stock companies encounter agency problems that arise when the interests of shareholders and the management differ. Corporate governance is the enforced discipline on the management designed and devised to alleviate the agency problems, and a structure to seek the alignment of interests of shareholders and the management.

The global financial crisis - the so-called Lehman Shock in Japan - has revealed the weakness in corporate governance in the financial industry. Reflecting on this experience, the United Kingdom abolished the Combined Code, which had been the U.K.'s corporate governance code since 1999, and replaced it with the newly developed Corporate Governance Code and the Stewardship Code in 2010. The stewardship responsibilities by institutional shareholders (prescribed in Stewardship Code) have been added to the existing monitoring by the independent board of directors (prescribed in Corporate Governance Code) to strengthen governance.

Three years later, the Stewardship Code was formulated relatively in an abrupt manner[1] in Japan as the Japan Revitalization Strategy, i.e., 3rd arrow of Abenomics. It was the start of corporate governance reform. The following year, the Corporate Governance Code was also formulated as a revised Japan Revitalization Strategy 2014, following the Stewardship Code's formulation. Both Codes stipulate their purposes as proactive governance aiming for sustainable corporate growth (increase in corporate value over the mid to long-term.) The rapid-fire formulations of the Codes without runups surprised foreign institutional investors who had been concerned about the Japanese corporations' governance. The Corporate Governance Code's requirement for appointment of independent directors especially garnered attention and praise as a turnaround of Japan's stance, which had been considered negative for outside directors. The Code is the set of rules to "Comply or Explain" and not legally binding. Nevertheless, Japanese companies have been proactively appointing independent directors, and 93% of the listed companies on the First Section of the Tokyo Stock Exchange (TSE) have appointed two or more independent directors in 2019, according to TSE. In this report, we examine if the governance of Japanese corporations has shifted drastically.

To capture the shift in corporate governance in Japanese corporations, Nikko Research Center, Inc. developed the governance evaluation model (Governance Research Scores:

1 It indicates that the considerations similar to the ones on the UK's Walker Report had not been given.

GR Scores) using benchmarking based on the Corporate Governance Code. While laws and legislations indicate the bars to which the companies at least comply, the Corporate Governance Code shows how they should be i.e., the best practices. Therefore, using the Code as a benchmark, the GR Scores measure each company's distance from the benchmark and score it. As such, the shorter the distance, the stronger the governance. In addition to Japan's Corporate Governance Code (domestic standard), the GR Scores also measure the distance from the global base using the ICGN Global Governance Principles as the global standard. We have started benchmarking on the top 100 companies by market cap in 2017 and published the annual results in Nikko Research Review ever since[2]. In 2020, the fourth year, we report the detailed governance status of the 111 companies, which are subject to evaluation by the GR Scores in addition to the results of the GR Scores 2020.

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2 Terayama and Sugiura (2018a), Terayama and Sugiura (2018b), Terayama and Sugiura (2019)

Executive Summary

Chapter 1 The GR Scores 2020 Status

The GR Scores 2020 evaluates the initiatives for corporate governance taken mainly at the 111 listed Japanese companies with the top market cap (hereafter referred to as "the 111 companies".) The Score adopts the Corporate Governance Code as the domestic standard and the ICGN Global Governance Principles as the global standard for benchmarks. It covers all the aspects required by both codes (nine themes,) and evaluates 35 items by the domestic standard and 36 items by the global standard, allocating one (1) point for performing and zero (0) point for non-performing. The GR Scores can be obtained by counting performing items and translating their points into percentages. Therefore, the GR Scores measure each company's governance level using the degree of attainment based on domestic and global standards against 100% as a benchmark.

The GR Scores 2020 averages are 54.2 and 25.5 respectively by domestic standard and global standard, increased 3.3 points and 1.8 points respectively from the previous year. Eisai Co., Ltd. recorded the highest points by domestic and global standards (80 by domestic and 46 by global standard) for the second consecutive year. Looking at the histogram, points by the domestic standard show close to the normal distribution, while most companies' points by the global standard are concentrated near the average, and no company exceeds 50%.

Over the past four years, the GR Scores' shift shows a gradual increase in the medians by both domestic and global standards. While the domestic standard points are increasing as a whole, distribution by the global standard is spreading upward. It indicates that the companies obtaining more scores due to strengthened governance initiatives and those without any change are more polarized.

By theme, the scores are high for "General shareholders meeting" and low for "Leadership and independence" by both domestic and global standards. The item "Risk oversight" is not contained in Japan's Corporate Governance Code in the first place, and its points are the lowest by the global standard, indicating that the board of Japanese companies have little interest in risk management. The item with the most significantly moved points in four years is "Remuneration" by both domestic and global standards. It is likely to be influenced by the facts that many companies have adopted a restricted stock remuneration system, and the regulation on the disclosure of remuneration in the annual securities report has been tightened.

The governance reform should have exerted impact equally on the 111 companies. However, widely varied distribution of the GR Scores and shifts overtime at each company make us wonder where these differences in the strength of corporate governance efforts come from. Corporate governance is a structure to alleviate the agency problems that arise when the interests of shareholders and the management differ. It seeks the alignment of interests of shareholders and the management through enforcing disciplines on or giving incentives to the management. It is left to the management whether to strengthen the governance or not, but it is minority shareholders such as institutional investors who demand the governance. Therefore, the ownership by minority shareholders leads to strengthen the governance (Enforced discipline effect.) On the other hand, when the insiders and the management hold many shares in a company, they are likely to be inactive for strengthening corporate governance (Insider effect.) Furthermore, the management of companies with sound performance might have strong negotiation power to brush aside requests for strengthening governance (Performance effect.) As a result of analyzing these hypotheses with the GR Scores data for four years, we could not confirm the enforced discipline effect by ownership of external shareholders such as institutional investors and foreign investors. Meanwhile, the insider effect was found as stable shareholders, ownerships by the CEO, and cross-shareholdings negatively affect the GR Scores. However, controlling shareholders gave positive impact on the GR Scores. ROA also affected negatively on the GR Scores, confirming the performance effect.

The purpose of the Corporate Governance Code is the "Proactive Governance" aiming for sustainable corporate growth (increase in corporate value over the mid to long-term) based on the assumption that strengthened governance is connected to increased corporate value. Accordingly, we look at the relationship between the corporate governance and corporate value. First, we compared the industrially adjusted PBR of one year ahead for the upper-ranked and lower-ranked companies with the GR Scores but found no significant difference.

The minority shareholders, such as institutional investors, are expected to demand strengthened governance to increase corporate value. On the other hand, the insiders, including stable shareholders, are not likely to require the governance for increasing corporate value (proactive Governance.) The companies owned by many insiders could be fixing the outward appearance of governance for other purposes. Therefore, when the institutional investor ownership rate is more than 50%, the group of companies is defined where the voice of minority shareholders reaches the management. When the rate is 50% or less, the group of companies is defined where the minority shareholders

do not voice. These two groups are further divided into four groups by higher GR Scores and lower GR Scores to compare the corporate value index. We found a difference in the index between the group of companies with more than 50% of institutional investor shareholders and the group of companies with 50% or less institutional investor shareholders. The corporate value is higher at the group of companies with more than 50% of institutional investor shareholders and high GR Scores than the group of companies with 50% or less institutional investor shareholders and high GR Scores. It confirms the Corporate Governance Code's assumption that at the companies that strengthen governance in response to the request for strengthening governance by institutional investors, the strengthened governance leads to improvements in the corporate value.

Chapter 2 Governance Status of the 111 companies with GR Scores

1. Board of directors

Given the management oversight by an independent board is fundamental to the corporate governance globally, strengthening the board' independence and brushing up its decision-making capability would lead to enhanced corporate governance. As such, the following five elements are considered effective: (1) Nomination and Remuneration Committees, (2) Independent chairperson, (3) Diversity, (4) Lead independent director, and (5) Executive sessions.

On the other hand, in Japan, the board of directors has been historically comprised mainly of internal directors, and many of them have engaged in business executions. While the domestic standard recommends all five elements mentioned above, it sets the number of independent directors at a minimum of two, not requiring board's independence with the majority of independent directors. However, 70% of the 111 companies appoint one-third or more outside directors. Of which, twenty companies' board has a majority of outside directors, fulfilling the global standard with an independent board of directors.

While the global standard requires an independent chairperson, the president or the chairperson with the right to represent the company chairs the board of directors at many of the 111 companies, and the independent chairperson is rarely found. Meanwhile, with a gender diversity viewpoint, 76% of the 111 companies appoint one or more female directors. The companies with no female directors are in the minority.

Moreover, globally, the effectiveness of lead independent directors is profoundly recognized. They are expected to play important roles not only by substituting independent chairperson but also at the executive sessions. Although the domestic standard also recommends, most 111 companies have not appointed the lead independent director under the present circumstances.

In theory, it is the nomination committee that requires the board of directors' evaluation. The nomination committee's role is to reappoint directors or search for new director candidates to fill in the gaps between the board evaluation results and the optimal board structure. However, the board evaluation by the domestic standard focuses on the effectiveness of the current board. The board's evaluation at the 111 companies focuses on analyzing and evaluating whether the board functions effectively, generally in line with the domestic standard, and it is not the reporting item of the nomination committee.

2. Committee

Of the 111 companies, 30 companies have established a nomination and remuneration advisory committees, and 68 companies have established a nomination and a remuneration committee separately. Thus, the rate of the companies which have established committee reaches 88%. However, there is no significant difference in the committee composition, including the number of members, the attribution of outside directors, and the number of female members between the nomination committee and the remuneration committee. It made clear that the members often serve concurrently for both committees even if the committees are established separately.

Furthermore, though the committees established with an even number of members could raise the question of whether they are premised to make decisions, the research found that 37 companies for nomination committee and 40 companies for remuneration committee, have comprised of even number of members.

The global standard requires disclosure of the roles (bylaws) of the nomination committee and the remuneration committee. The common roles for both committees include monitoring conflict of interest, an outside consultant's appointment, and dialogue with shareholders. However, no description (except for one company describing monitoring of conflict of interest as a role of the nomination committee) of these roles was found, indicating that they are not likely to be recognized as both committees' roles at this stage.

As for the independence of the nomination and remuneration committees, the independent director rate was more than 50% at 49 companies' nomination committees

and 44 companies' remuneration committees respectively out of 74 and 71 companies that have their committees as decision making bodies (with an odd number of members.) The independent committees have already been in the majority. Moreover, the independent directors are appointed as the committee chair in many cases, while at 43 nomination committees and 36 remuneration committees, a considerable number of companies, the president takes part in the committees.

Six of the companies with a nominating committee, etc. go beyond the global standard, having all committee members with independent directors. Such completely independent committees do not need to matter the independent director rate, the committee chairperson's attribution, and the president or company chairperson's presence, and the transparency of nomination and remuneration processes can be secured.

3. Remuneration

In the corporate governance system, the management remuneration is the only way to align the interests of shareholders and the management and solve agency problems. But it is not easy to design the remuneration that properly incentivizes the management toward the creation of long-term corporate value. The introduction of mid to long-term incentives, especially the adoption of stock-linked remuneration, is recommended. Although the rate should be set out properly, the specific target is not fixed.

Of the 111 companies with the GR Scores, 65 companies have introduced mid to long-term incentives. Of those, 62 companies disclose the remuneration structure, which comprises 47% base remuneration, 26% short-term incentives, and 31% long-term incentives on average. Compared with the U.K. and the U.S., the base remuneration rate is higher, and the long-term incentive rate is lower in Japan.

Both global and domestic standards recommend the restricted stock among the long-term incentives because it simply helps to align the interests of shareholders and the management. Currently, 86 companies (77%) adopt the restricted stock, significantly up from 33% of the GR Scores 2018 two years ago, which is also a factor for higher GR Scores. It is considered because of the tax reform in 2016 and the revision of Japan's Corporate Governance Code that the adoption of the restricted stock has progressed.

Many companies disclose their remuneration design in which most companies use profitability related indexes such as current operating profit, current net profit, and ROE. Albeit only a few, some companies include non-financial indexes such as ESG targets. Most companies disclose only the indexes, but 23 companies also show the relationship between the indexes and the remuneration. Nine of those companies explain the

relation between the mid to long-term indexes and the management remuneration.

The global standard recommends incorporating a malus or a clawback clause in the management remuneration to deal with infidelities conducted by the management. Twenty-nine companies incorporate these clauses, and the companies that include the clawback clause are especially increasing. Furthermore, as for the remuneration of non-executive directors (NED), such as independent directors, the global and domestic standards assimilate on the point that it does not grant performance-based payment. The global standard further requires the NED remuneration to be aligned with shareholders' interests. Ninety-five companies deny performance-based payment, resulting in the situation that most companies grant fixed remuneration only. Meanwhile, four companies have adopted the stock remuneration system for NED.

The global standard requires disclosure of the remuneration report by the remuneration committee. Japanese statutory disclosure obliges the individual disclosures of the director's name who received 100 million yen or more remuneration and the amount only, and there is no statutory disclosure obligation analogous to them. Therefore, no company disclosed the remuneration report required by the global standard.

4. Cross-shareholdings

As the global standard denies the cross-shareholdings from the perspectives of decrease in capital efficiency (hollowing out of capital) and maneuver for stable shareholders (hollowing out of voting right,) there is no relevant principle in the ICGN Global Governance Principles (global standard.) In contrast, Japan's Corporate Governance Code obviously denies the cross-shareholdings as a maneuver for stable shareholders, but takes the stance that the benefits and risks associated with the cross-shareholdings meet the cost of capital, i.e., rational cross-shareholdings from the capital efficiency viewpoint could exist, thus, requires disclosure of its rationality.

Of the 111 companies, only three companies, Japan Post Insurance, Komatsu, and Orix Corporation, did not have cross-shareholdings. The remaining 108 companies held cross-shares, although the holding volume varies. The Corporate Governance Code requires the examination of the rationality by the board, disclosure of reduction policy, and disclosure of intention not to hinder the sales by cross-shareholders, and 50 companies assert that they examined the rationality of holdings by the cost of capital. Furthermore, eight companies "explained" the reason to hold the cross-shareholdings other than the examined rationality by the cost of capital. In addition, 51 companies disclosed the reduction policy and its results. However, only five companies disclosed all three items,

i.e., examined rationality, established reduction policy, and declared intention not to hinder sales of cross-shareholders.

At eighty-seven companies among the 108 companies excluding the three with no cross-shareholdings, "Shareholdings" in the annual securities report were confirmed. The total amount of holdings at the 87 companies was 25 trillion yen, with the largest amount of 4 trillion yen at Mitsubishi UFJ Financial Group and the smallest of 5 million yen at Japan Post Bank. At the 87 companies, the holding amounts were large in the insurance, banking, and wholesale industries.

In FY2018, the total sales amount was 1.52 trillion yen, and the total purchase amount was 456.0 billion yen, resulting in a net decrease in the holding amount of cross-shareholdings. When it comes to unwinding of cross-shareholdings, both sides do not necessarily sell off the shares. Some companies posted not only sales gains but also sales losses, suggesting that they have gone further into unwinding of shareholdings regardless of valuation gains or losses. In contrast, seven companies increased the net amount of cross-shareholdings despite establishing the reduction policy. The increase is mainly to maintain and strengthen the business relationship, but partially due to the supplier stock ownership association.

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The Companies Covered by the GR Scores 2020

Securities code	Company Name	Securities code	Company Name
1605	INPEX	6902	DENSO
1878	DAITO TRUST CONSTRUCTION	6954	FANUC
1925	DAIWA HOUSE INDUSTRY	6971	KYOCERA
1928	SEKISUI HOUSE	6981	MURATA MANUFACTURING
2267	YAKULT HONSHA	6988	NITTO DENKO
2269	MEIJI HOLDINGS	7011	MITSUBISHI HEAVY INDUSTRIES,
2502	ASAHI GROUP HOLDINGS,	7181	JAPAN POST INSURANCE
2503	KIRIN HOLDINGS	7182	JAPAN POST BANK
2587	SUNTORY BEVERAGE & FOOD	7201	NISSAN MOTOR
2802	AJINOMOTO	7203	TOYOTA MOTOR
2914	JAPAN TOBACCO	7259	AISIN SEIKI
3382	SEVEN & I HOLDINGS	7267	HONDA MOTOR
3402	TORAY INDUSTRIES,	7269	SUZUKI MOTOR
3407	ASAHI KASEI	7270	SUBARU
4063	SHIN-ETSU CHEMICAL	7309	SHIMANO
4188	MITSUBISHI CHEMICAL HOLDINGS	7733	OLYMPUS
4324	DENTSU	7741	HOYA
4452	KAO	7751	CANON
4502	TAKEDA PHARMACEUTICAL	7974	NINTENDO
4503	ASTELLAS PHARMA	8001	ITOCHU
4507	SHIONOGI	8031	MITSUI
4508	MITSUBISHI TANABE PHARMA	8035	TOKYO ELECTRON
4519	CHUGAI PHARMACEUTICAL	8053	SUMITOMO
4523	EISAI	8058	MITSUBISHI
4528	ONO PHARMACEUTICAL	8113	UNICHARM
4543	TERUMO	8267	AEON
4568	DAIICHI SANKYO	8306	MITSUBISHI UFJ FINANCIAL
4578	OTSUKA HOLDINGS	8309	SUMITOMO MITSUI TRUST HOLDINGS
4661	ORIENTAL LAND	8316	SUMITOMO MITSUI FINANCIAL GROUP
4689	Z HOLDINGS	8411	MIZUHO FINANCIAL GROUP,
4755	RAKUTEN,	8591	ORIX
4901	FUJIFILM HOLDINGS	8604	NOMURA HOLDINGS
4911	SHISEIDO	8630	SOMPO HOLDINGS,
5020	JXTG HOLDINGS,	8725	MS&AD INSURANCE GROUP HOLDINGS
5108	BRIDGESTONE	8750	DAI-ICHI LIFE HOLDINGS,
5401	NIPPON STEEL	8766	TOKIO MARINE HOLDINGS,
5411	JFE HOLDINGS,	8801	MITSUI FUDOSAN
5802	SUMITOMO ELECTRIC INDUSTRIES,	8802	MITSUBISHI ESTATE
6098	RECRUIT HOLDINGS	8830	SUMITOMO REALTY & DEVELOPMENT
6178	JAPAN POST HOLDINGS	9020	EAST JAPAN RAILWAY
6201	TOYOTA INDUSTRIES	9021	WEST JAPAN RAILWAY
6273	SMC	9022	CENTRAL JAPAN RAILWAY
6301	KOMATSU	9201	JAPAN AIRLINES
6326	KUBOTA	9202	ANA HOLDINGS INC.
6367	DAIKIN INDUSTRIES,	9432	NIPPON TELEGRAPH & TELEPHONE
6501	HITACHI,	9433	KDDI
6502	TOSHIBA	9434	SOFTBANK
6503	MITSUBISHI ELECTRIC	9437	NTT DOCOMO
6594	NIDEC CORPORATION	9503	KANSAI ELECTRIC POWER
6702	FUJITSU	9531	TOKYO GAS
6723	RENESAS ELECTRONICS	9613	NTT DATA
6752	PANASONIC	9735	SECOM
6753	SHARP	9843	NITORI HOLDINGS
6758	SONY	9983	FAST RETAILING
6861	KEYENCE	9984	SOFTBANK GROUP CORP.
6869	SYSMEX		

Contents

Chapter 1　The GR Scores 2020

1. The GR Scores 2020 Summary

1.1. Evaluation Method of the GR Scores

The GR Scores 2020 evaluates the initiatives for governance taken at the 111 Japanese companies by the Corporate Governance Code (for domestic standard) as a benchmark. The Score adopts the ICGN Global Governance Principles (for global standard) also as a benchmark.

All evaluation items of domestic and global standards are categorized into nine themes; "Board role and responsibilities," "Leadership and independence," "Composition and appointment," "Corporate culture," "Risk oversight," "Remuneration," "Reporting and audit," "Shareholder meetings," and "Shareholder rights."

Each evaluation item has three or two scales of its own, allocating one point for Level 3, 0.5 points for Level 2, and zero for Level 1. Upon sum up these points, the GR Scores translates it into percentage. The GR Scores 2020 evaluates the information disclosed by the end of December 2020.

The GR Scores 2020 evaluates 35 items and 36 items respectively by domestic and global standards (see Figure 1.) Please refer to Appendix 1 for all evaluation items[3].

Figure 1　The No. of Evaluation Items by Theme for the GR Scores 2020

Themes	Definition	# of evaluation items	
		Domestic (35)	Global (36)
Board role and responsibilities	The policies governing the roles and responsibilities of the board, directorship and shareholder engagements.	6	2
Leadership and independence	The effectiveness of monitoring the performance of the CEO by the board.	7	5
Composition and appointment	The policies governing the board structure and the process of nominating the board of directors	7	6
Corporate culture	The approach to corporate culture, including ethical perspectives and compliance for directors, managers, and employees.	2	3
Risk oversight	The approach of the board of directors to risk oversight.	0	3
Remuneration	Policies and processes concerning remuneration.	3	6
Reporting and audit	Reporting and auditing policies, financial statements, internal control reports and CSR reports.	2	4
Shareholder meetings	Policies concerning shareholder meetings and voting agenda.	2	2
Shareholder rights	Policies concerning shareholders rights and protection of minority shareholders.	6	5

Source: Prepared by Nikko Research Center

3　Refer to Terayama and Sugiura (2018a, 2018b, 2019) for the past scores.

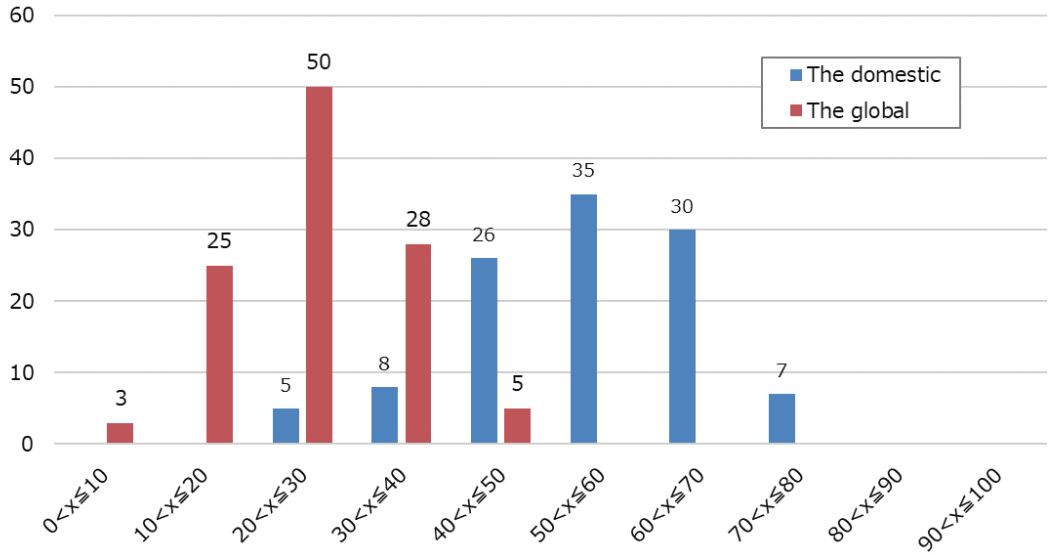
2. The GR Scores 2020 Status

2.1. Overall Score Status

First, the average of overall scores by domestic standard was 54.2, up 3.3 points from the last year, and the median was also up 2.5 points. The highest score was 80%, while the lowest was 23%. Meanwhile, the average was 25.5, up 1.8 points from last year, and the median was up 0.5 points by the global standard. The highest score was 46%, while the lowest was 6%. However, no statistically significant difference was confirmed in any changes[4].

As the histogram shows, the scores by domestic standard are mostly distributed in the range of "60 ＜ x ≦ 70" and "40 ＜ x ≦ 50", with "50 ＜ x ≦ 60" at the top. By the global standard, the scores are mostly distributed in the range of "30 ＜ x ≦ 40" and "10 ＜ x ≦ 20", with "20 ＜ x ≦ 30" at the top (see Figure 2.)

Figure 2　The Distribution of the GR Scores 2020 by Domestic and Global Standards



Source: Prepared by Nikko Research Center

Looking at the TOP 10 companies of overall Score, the top-ranked companies by the domestic standard include Eisai (80%), Sumitomo Mitsui Trust Holdings (79%), and Mitsubishi Heavy Industries (77%), and by the global standard include Eisai (46%), Japan Post Insurance (46%), and Toshiba (43%.) There were six companies, such as Eisai, Sumitomo Mitsui Trust Holdings, and Toshiba ranked within the top 10 by domestic and global standards (shown in bold.)

4　We set the significance level at 5%. Unless otherwise described, it remains the same for the statistical tests hereunder.

Figure 3　Top 10 Ranked Companies and Their Overall Scores

code	company name	Domestic score	Domestic rank	code	company name	Global score	Global rank
4523	**EISAI**	80	1	**4523**	**EISAI**	46	1
8309	**SUMITOMO MITSUI TRUST HOLDINGS**	79	2	7181	JAPAN POST INSURANCE	46	1
7011	MITSUBISHI HEAVY INDUSTRIES,	77	3	**6502**	**TOSHIBA**	43	3
6502	**TOSHIBA**	76	4	**8306**	**MITSUBISHI UFJ FINANCIAL**	43	3
8725	**MS&AD INSURANCE GROUP HOLDINGS**	74	5	8604	NOMURA HOLDINGS	43	3
5020	JXTG HOLDINGS,	73	6	**8309**	**SUMITOMO MITSUI TRUST HOLDINGS**	40	6
6758	**SONY**	71	7	8411	MIZUHO FINANCIAL GROUP,	40	6
1878	DAITO TRUST CONSTRUCTION	70	8	**6758**	**SONY**	38	8
4543	TERUMO	70	8	4502	TAKEDA PHARMACEUTICAL	36	9
8306	**MITSUBISHI UFJ FINANCIAL**	70	8	7733	OLYMPUS	36	9
				8316	SUMITOMO MITSUI FINANCIAL GROUP	36	9
				8725	**MS&AD INSURANCE GROUP HOLDINGS**	36	9

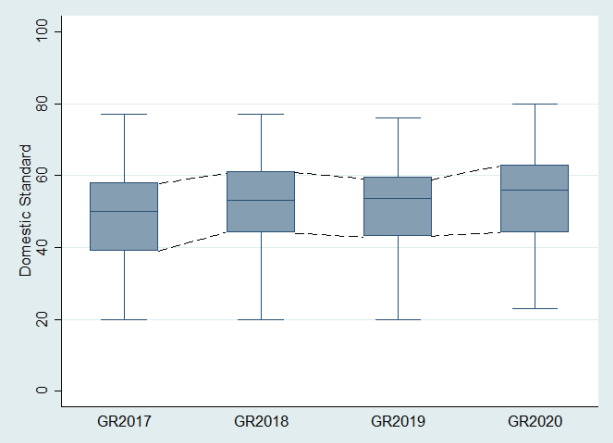
Source: Prepared by Nikko Research Center

2.2. Shift in Overall Scores Over the Past Four Years

This section explains how the scores shifted from the GR Scores 2017 through 2020[5].

Figure 4 shows the boxplots on the overall scores by domestic standard and each of their quantiles. By domestic standard, the median increased six points from 50 to 56, five points from 58 to 63 in top-ranked scores (top quantile,) and five points from 39 to 44 in bottom-ranked score (bottom quantile) from 2017 through 2020. It indicates that the companies in this sample have been steadily strengthening their corporate governance throughout the four years.

Figure 4　Shift in Overall Scores by Domestic Standard



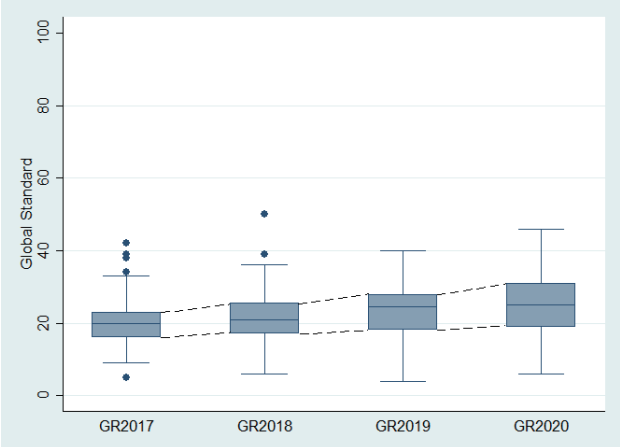
Domestic standard	GR score 2017	GR score 2018	GR score 2019	GR score 2020
75 percentile	58	61	59.5	63
median	50	53	53.5	56
25 percentile	39	44	43	44

Source: Prepared by Nikko Research Center

5　Please refer to Appendix 2 for descriptive statistics value over the past four years.

Meanwhile, by the global standard, the median increased five points from 20 to 25, eight points from 23 to 31 in top-ranked scores from 2017 through 2020. However, the increase in bottom-ranked Score stays at three points from 16 to 19 (see Figure 5.) In other words, in the global standard case, the companies that have promoted enhancement in governance, and those that have not are more polarized year by year.

Figure 5　Shift in Overall Scores by the Global Standard



Global standard	GR score 2017	GR score 2018	GR score 2019	GR score 2020
75 percentile	23	25.5	28	31
median	20	21	24.5	25
25 percentile	16	17	18	19

Source: Prepared by Nikko Research Center

2.3. The GR Scores 2020 by Theme

Secondly, we confirm the status of the GR Scores 2020 by theme (see Figure 6.) By domestic standard, "Shareholder meetings (81.8)," "Remuneration (80.6)," and "Reporting and audit (69.8)" obtained relatively high scores, while "Leadership and independence (37.1)," "Board role and responsibilities (46.0)," and "Corporate culture (48.0)" obtained relatively low scores.

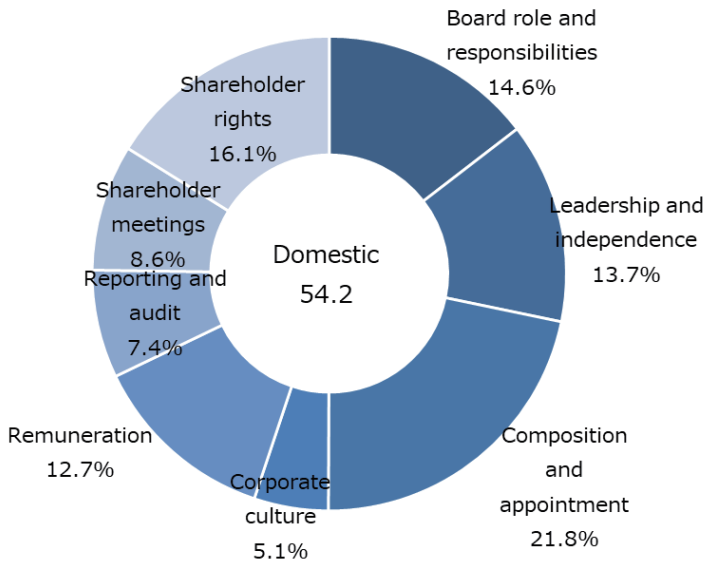
Comparing the GR Scores 2020 with the GR Scores 2019 and 2017, "Remuneration" has most increased by both domestic and global standards, and the statistically significant difference was also confirmed. The factors for the domestic standard changes include the disclosure of directors' remuneration in the securities reports, especially the specific indicators on the ratio of remuneration by cash and stocks as well as performance-based remunerations.

Concerning the contributions to the overall GR Scores from the sub-scores by theme

(Weight of Evaluation Items by Theme × Sum of scores by theme / Sum of all theme scores,) "Composition and appointment (21.8%)," "Shareholder rights (16.1%)," and "Board role and responsibilities (14.6%)" were identified as primary factors of the scores.

Figure 6　Domestic Standard Sub-scores by Theme and their Contribution to Overall Scores

Domestic standard	# of samples	mean	standard error	minimum	maximum	Subtracting from GR2019	Subtracting from GR2017
Shareholder meetings	111	81.8	21.3	0	100	-2.7	-5.2
Remuneration	111	80.6	20.7	0	100	12.8	48.7
Reporting and audit	111	69.8	27.6	0	100	3.4	2.3
Composition and appointment	111	59.1	17.3	7	100	5.3	2.8
Overall	111	54.2	12.0	23	80	3.3	5.7
Shareholder rights	111	51.0	14.4	17	83	3.3	-3.2
Corporate culture	111	48.0	28.2	0	100	0.1	1.0
Board role and responsibilities	111	46.0	18.9	17	92	1.7	4.0
Leadership and independence	111	37.1	15.7	14	79	0.9	0.4



Source: Prepared by Nikko Research Center

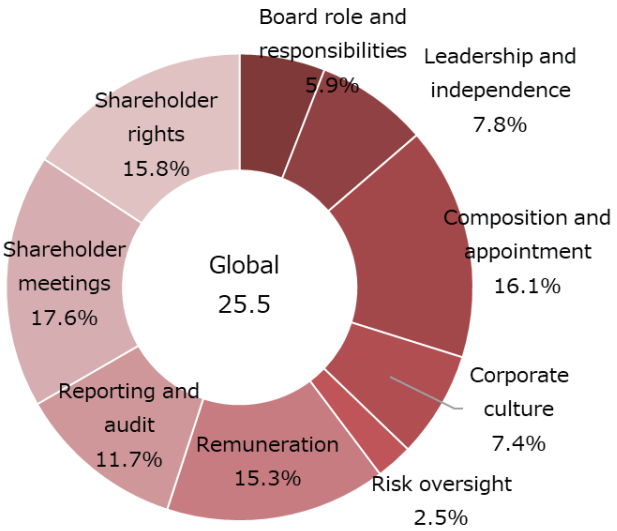
Then, as shown in Figure 7, sub-scores by theme based on the global standard indicate that "Shareholder meetings (80.9)" obtained a high score, while "Risk oversight (7.8)" and "Leadership and independence (14.3)" obtained low scores. Same with domestic standard, "Remuneration" has most increased in the comparison between the GR Scores 2019 and the GR Scores 2017, indicating the statistically significant changes. These changes are attributed to the introduction of the restricted stock remuneration

system at many companies.

Also, looking at the contributions by the global standard, "Shareholder meetings (17.6%)," "Composition and appointment (16.1%)," and "Shareholder rights (15.8%)" contributed highly.

Figure 7 Global Standard Sub-scores by Theme and their Contribution to Overall Scores

Global standard	# of samples	mean	standard error	minimum	maximum	Subtracting from GR2019	Subtracting from GR2017
Shareholder meetings	111	80.9	13.5	25	100	1.0	2.4
Shareholder rights	111	29.0	8.4	0	70	1.2	1.6
Board role and responsibilities	111	27.3	26.2	0	75	1.6	6.3
Reporting and audit	111	26.8	10.0	13	63	1.6	-4.4
Overall	111	25.5	7.9	6	46	1.8	4.6
Composition and appointment	111	24.8	14.1	8	75	2.3	6.5
Remuneration	111	23.5	13.9	0	58	4.8	19.4
Corporate culture	111	22.6	15.9	0	83	-0.1	2.3
Leadership and independence	111	14.3	15.4	0	60	0.3	1.7
Risk oversight	111	7.8	19.8	0	83	1.5	0.8



Source: Prepared by Nikko Research Center

3. Factors for Strengthened Corporate Governance

Corporate governance is a scheme to enforce a discipline on the management or align the interests of shareholders and the management to alleviate the agency problems that arise when shareholders' interests and the management's differ. The corporate governance initiatives at the 111 companies Scores vary, as shown in their widely spread scores from 23 to 80 by domestic standard. The shifts in scores also vary

by company. As indicated by the global standard, some companies stay at a low level without strengthening governance at all throughout the four years, while some others are at a high level through further enhancement in governance. The management itself could determine these strengths in corporate governance optimally, but various factors could have affected them. For example, requests from minority shareholders such as institutional investors could impact the strengths, while there may not be any necessity to strengthen governance as the management aligns their interests with shareholders' due to sound corporate performance. When the holding ratio of insider shareholders such as the management is high, the strengthening of governance may not be required.

Therefore, in this section, we confirm exogenous factors for corporate governance initiatives taken at the 111 companies. First, we examine the hypothesis that is considered an exogenous factor and then perform empirical analysis.

3.1. Hypothesis

One of the factors that strengthen corporate governance is enforced discipline on the management. In particular, under the situation where minority shareholders such as institutional investors are sufficiently diversifying, monitoring costs are high for shareholders. Thus, it could lead to the requests of strengthening governance by the board of directors. The previous studies confirmed that institutional investors influence corporate governance (McCahery et al. (2010), Aggarwal et al. (2011), Harford et al. (2014), Bebchuk et al. (2017).) Therefore, the first hypothesis is that holdings by minority shareholders such as institutional investors, foreign shareholders, and small unit investors strengthen corporate governance. In this report, we call this effect the "Enforced discipline effect."

On the other hand, when insiders hold many shares in a company, it could lead to the company being inactive for strengthening corporate governance. Insiders are, for example, companies that are strongly affected by the founding family, listed subsidiaries, companies that are high in cross-shareholdings, and companies that have many stable shareholders. These companies containing many insiders might not be required to strengthen governance, as they align the management's and insiders' interests. Also, in the cases where the management holds many shares in a company, strengthening of governance would not be required, as the interests of the management and minority shareholders are aligned (Raheja (2005), Linck et al. (2008).) Accordingly, we call these effects the "Insider effect."

Lastly, another reason to be inactive for governance is the corporate performance

status. Especially, the management of companies with sound performance is not required to strengthen governance as they have strong negotiation power at the board of directors (Hermalin and Weisbach (1988), Hermalin and Weisbach (2003).) Therefore, we call this effect the "Performance effect."

In this report, we examine the influences on corporate governance initiatives by "Enforced discipline effect," "Insider effect," and "Performance effect." In addition to these effects, the analysis added interest-bearing debt ratio, company's age, total assets, year dummy, and manufacturing dummy variables as control variables to control the influence because of the differences in financial condition, asset size, maturity of the company and industry. In this analysis, the each of parameters are regressed by the ordinary least squares.[6]. The specific variables and hypotheses are summarized as follows.

Enforced discipline effect : (Domestic) Institutional investor ratio, Small unit investor ratio, Foreign investor ratio

Insider effect : Cross-shareholding ratio, Stable shareholder ratio, CEO holding ratio, Family-owned company dummy, Controlling shareholder dummy, Cross-shareholding ratio (Cross-shareholding amount divided by total assets)

Performance effect : ROA

Control variables : I Debt to Asset ratio, Company's age, Total assets, Year dummy, Manufacturing dummy

All of these variables use data from Nikkei NEEDS-Cges and Nikkei financial data. We have winsorized at 1%. Furthermore, since the cross-shareholding ratio data are recorded only for the past three years, we have conducted two types of analysis for the cases of inclusion and non-inclusion of this variable in the explanatory variables. For dependent variable, overall score levels by domestic and global standards (provided, however, that the scores are divided by 100 to standardize) and their variations (subtract Timepoint T-1 Score from Timepoint T Score.)

3.2. Descriptive Statistics and Analysis

At first, we look at the descriptive statistics of each variable at the 111 companies (see Figure 8.)The shareholder composition in this sample shows the average of 16% for the ratio of institutional investors who are external shareholders, and 34% for foreign investors. Also, the average is 22% for the ratio of stable shareholders who are

6 For the standard error, the cluster-robust standard error for each company is used.

insiders. Besides, family-owned companies accounted for 31% and controlling shareholders, 8% of all samples.

Figure 8　Descriptive Statistics

variables	#of samples	mean	standard error	minimum	maximum
institutional investors ratio	419	0.16	0.07	0.00	0.33
small unit investors ratio	388	0.08	0.05	0.01	0.26
foreigh invstors ratio	419	0.34	0.13	0.02	0.72
cross-shareholders ratio	419	0.07	0.07	0.00	0.37
stable shareholders ratio	419	0.22	0.19	0.00	0.89
CEO holdings ratio	419	0.01	0.03	0.00	0.21
cross-shareholdings ratio	316	0.04	0.04	0.00	0.27
total asset (log)	370	14.95	1.11	12.76	19.47
ROA	347	0.08	0.05	0.02	0.22
debt to asset ratio	370	0.15	0.14	0.00	0.65
Company's age (log)	419	3.91	0.75	2.08	4.74
industry-adjusted P/B	370	0.43	0.53	-1.35	1.69
family-owned company dummy	419	0.31	0.46	0.00	1.00
controlling shareholder dummy	419	0.08	0.27	0.00	1.00

Source: Prepared by Nikko Research Center

We indicate the analysis results hereunder. Figure 9 shows the regression analysis results for domestic standard levels and variations. (1) and (3) are the results, including the cross-shareholding ratio, while (2) and (4) are the results of non-inclusion of the ratio.

First, the enforced discipline effect indexes, such as the institutional investor ratio and foreign investor ratio, did not show any influence by external shareholders.

Of the indexes for the insider effect, stable shareholder ratio, CEO holding ratio, and cross-shareholding ratio show significantly positive. These results suggest that governance is weak at the companies held at a high rate by insiders and the companies with many cross-shareholdings. By contrast, the controlling shareholder dummy showed significantly positive results, revealed the opposite results to the hypothesis. Given that controlled companies such as listed subsidiaries have difficulties protecting minority shareholders' interests in general, they could be fixing the outward appearance of governance for other purposes. The ROA's significantly negative results also revealed that the management's negotiation power negatively influences governance initiatives.

Secondly, looking at domestic standard variation results, institutional investor ratio and small unit investor ratio are significantly negative, indicating the opposite result to the hypothesis. It revealed the results that the companies which are low in holdings by institutional investors strengthen governance initiatives. The CEO holding ratio results are significantly negative, supporting the insider hypothesis. The ROA variations results are also significantly negative, supportive of the performance effect.

Figure 9 Regression Analysis Results for Domestic Standard

variables	(1) d_total_00	(2) d_total_00	(3) d1_d_total_00	(4) d1_d_total_00
institutional investors	0.206	0.219	-0.108**	-0.116**
	(0.223)	(0.216)	(0.0483)	(0.0488)
small unit investors	0.302	0.445**	-0.174***	-0.164***
	(0.221)	(0.215)	(0.0561)	(0.0544)
foreigh invstors	0.0260	0.0569	0.00100	0.000467
	(0.0874)	(0.0859)	(0.0305)	(0.0295)
cross-shareholders	-0.164	-0.170	-0.0867	-0.0973*
	(0.173)	(0.157)	(0.0557)	(0.0511)
stable shareholders	-0.221***	-0.209***	-0.0175	-0.0136
	(0.0829)	(0.0768)	(0.0435)	(0.0447)
CEO holdings	-0.790**	-0.533*	-0.274**	-0.254**
	(0.344)	(0.316)	(0.130)	(0.126)
family-owned	-0.0141	-0.0209	0.000979	0.000159
	(0.0259)	(0.0263)	(0.00604)	(0.00585)
controlling shareholder	0.111***	0.116***	-0.0139	-0.0155
	(0.0398)	(0.0437)	(0.0221)	(0.0223)
cross-shareholdings	-0.574**		-0.0621	
	(0.228)		(0.0570)	
total asset	-0.0235	-0.0221	-0.00254	-0.00246
	(0.0158)	(0.0162)	(0.00415)	(0.00408)
ROA	-0.545*	-0.261	-0.294***	-0.266***
	(0.320)	(0.298)	(0.0927)	(0.0830)
debt to asset	-0.0113	0.0151	0.00280	0.00277
	(0.105)	(0.111)	(0.0294)	(0.0274)
Company's age	-0.0102	-0.00896	-0.00299	-0.00350
	(0.0154)	(0.0146)	(0.00555)	(0.00548)
Constant	0.934***	0.811***	0.155*	0.151*
	(0.256)	(0.263)	(0.0812)	(0.0794)
number of samples	239	319	228	231
R squared	0.331	0.284	0.210	0.198
model	OLS	OLS	OLS	OLS
year dummy	Yes	Yes	Yes	Yes
manufacturing dummy	all	all	all	all
the rage of samples	all	all	all	all

Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Source: Prepared by Nikko Research Center

The global standard results (see Figure 10) as with the domestic standard's, no

significance was confirmed for the institutional investors ratio and the foreign investor ratio. The cross-shareholding ratio and cross-shareholder ratio results are significantly negative for the insider hypothesis, the same with the domestic standard. The results of the controlling shareholder dummy are significantly positive, also the same as the domestic standard. Moreover, the results of ROA are also the same as the domestic standard, i.e., significantly negative.

As for the global standard variations, the CEO holding ratio results are significantly negative, supporting the insider hypothesis.

Figure10　Regression Analysis Results for the Global Standard

variables	(1) g_total_00	(2) g_total_00	(3) d1_g_total_00	(4) d1_g_total_00
institutional investors	0.0385	0.0306	-0.0300	-0.0339
	(0.142)	(0.133)	(0.0409)	(0.0404)
small unit investors	0.150	0.201	-0.0608	-0.0553
	(0.110)	(0.123)	(0.0453)	(0.0448)
foreigh invstors	-0.00407	0.0216	-0.0189	-0.0190
	(0.0486)	(0.0469)	(0.0173)	(0.0174)
cross-shareholders	-0.125	-0.192**	-0.0444	-0.0514*
	(0.0847)	(0.0791)	(0.0321)	(0.0305)
stable shareholders	-0.0860	-0.0833	-0.00913	-0.00740
	(0.0528)	(0.0517)	(0.0164)	(0.0165)
CEO holdings	-0.159	-0.00223	-0.181*	-0.171*
	(0.130)	(0.187)	(0.0957)	(0.0933)
family-owned	-0.00418	-0.00528	-0.00330	-0.00366
	(0.0167)	(0.0165)	(0.00406)	(0.00400)
controlling shareholder	0.0542**	0.0596**	-0.00329	-0.00389
	(0.0240)	(0.0250)	(0.0116)	(0.0115)
cross-shareholdings	-0.380***		-0.0357	
	(0.102)		(0.0303)	
total asset	-0.00152	-0.00129	0.00341	0.00354
	(0.00982)	(0.00972)	(0.00251)	(0.00243)
ROA	-0.361*	-0.242	-0.00740	0.00892
	(0.182)	(0.161)	(0.0644)	(0.0604)
debt to asset	-0.0912	-0.0570	0.00568	0.00648
	(0.0559)	(0.0621)	(0.0179)	(0.0171)
Company's age	0.00738	0.00514	0.00294	0.00272
	(0.00945)	(0.00942)	(0.00386)	(0.00375)
Constant	0.260*	0.222	-0.0242	-0.0278
	(0.155)	(0.155)	(0.0482)	(0.0468)
number of samples	239	319	228	231
R squared	0.303	0.260	0.042	0.038
model	OLS	OLS	OLS	OLS
year dummy	Yes	Yes	Yes	Yes
manufacturing dummy	all	all	all	all
the rage of samples	all	all	all	all

Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Source: Prepared by Nikko Research Center

Based on the above findings, it was confirmed that the 111 companies with sound corporate performance or highly held by insiders such as cross-shareholders or CEO do not strengthen governance initiatives. Moreover, the relationship in which the existence of minority shareholders, such as institutional investors, strengthen governance, which was seen in the previous studies, was not confirmed.

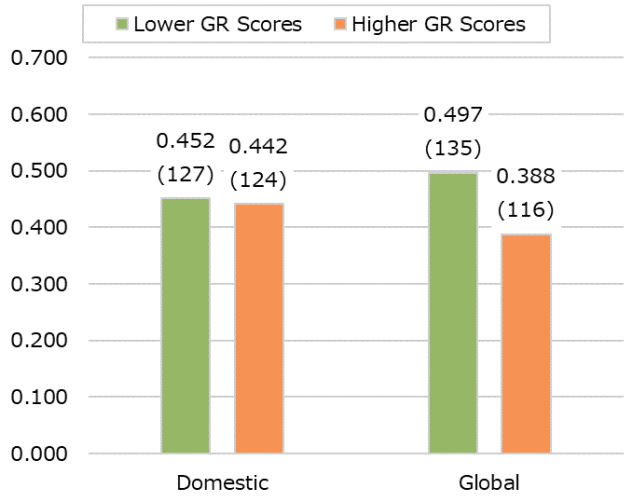
4. Relationship between Corporate Governance and Corporate Value

4.1. Does Corporate Governance Increase Corporate Value?

Next, we look at how the strengthening of corporate governance affects corporate value. The analysis mentioned above confirmed that controlled companies strengthen initiatives of corporate governance. At such companies, the interests may be aligned with controlling shareholders' interests but not with minority shareholders' interests, implying that they might be strengthening governance for other purposes. Therefore, in verifying the relationship between corporate governance and corporate value, the controlled companies, specifically, the eight companies held more than 50% by the controlling shareholders, are excluded from the following analysis, as it could be the obstructive factor.

The analysis uses the industry-adjusted price to book ratio of one year ahead as a corporate value index and overall scores of the GR Scores by domestic and global standards for corporate governance index to classify them based on each year's median. Figure11 shows the average of corporate value index by the GR Score quantiles. All of these averages are in the close rate and confirmed no statistically significant difference. As a result, no relationship was found between the strength of governance and corporate value.

Figure11　Results of Corporate Value Index by GR Score Quantile



*The figure in parentheses refer to the number of samples.

Source: Prepared by Nikko Research Center

4.2. Impact on Corporate Value based on the Institutional Investors Holdings

The analysis mentioned above confirmed that the strength of governance did not affect the corporate value. Indeed, the simple relationship between corporate governance and corporate value has not been found in previous studies. However, a recent study has focused on the existence of institutional investors and confirmed that monitoring by institutional investors influence corporate activities and corporate value (Harford et al. (2014), Crane et al. (2016), Saito et al. (2016).) In addition, it has been confirmed that strengthening governance supplementally influence corporate activities and corporate value at the same time with enforced discipline by institutional investors (Aggarwal et al. (2011), Miyajima, and Saito (2020).) Given the situation where governance initiatives are hardly influenced by domestic and foreign institutional investors based on the analysis in Section 3, institutional investors' holdings could enhance corporate value through direct impact on it and supplementally strengthened governance. Then, we classified the companies by institutional investors holding status and governance strength to compare the corporate value indexes average.

First, to classify the state into two categories, where the enforced discipline by institutional investors is effective or not, we used the index whether the total of domestic institutional investor ratio and foreign investor ratio exceeds 50% or not. Besides, as with the above analysis, we classified the state using the median of overall scores by domestic and global standards. We performed the multiple comparison analysis of the four groups' corporate value index classified by two thresholds and tested the differences. In this analysis, we believe that when the corporate value of the company group, whose institutional investor ratio exceeds 50% and GR Score is equal to or exceeding the median, is higher than the other groups, holdings by institutional investors supplemented with governance increase the corporate value.

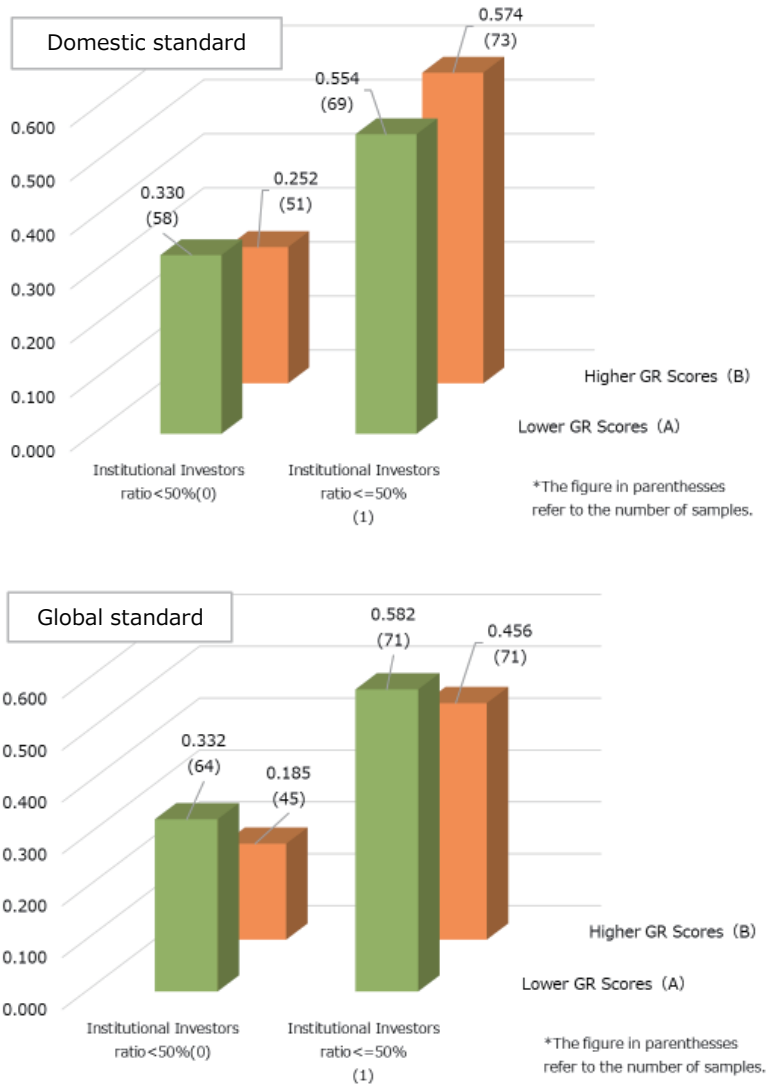
Figure 12 shows the average of the industrially adjusted PBR of the four groups. The definitions of the four groups are as follows; A1: group with institutional investor ratio 50% or more and lower GR Scores, B1: group with institutional investor ratio 50% or more and higher GR Scores, A0: group with institutional investor ratio less than 50% and higher GR Scores, and B0: group with institutional investor ratio less than 50% and lower GR Scores.

As shown in Figure 12, regardless of the GR Score, the number of samples for 50% or more of the institutional investor ratio surpasses that for less than 50% of the institutional investor ratio. By domestic standard, the B1 group's industrially adjusted PBR average is the highest at 0.574, confirming the significant difference with the B0 group's 0.252. Moreover, it also affirms the significant difference with the A1 group's

0.554. By the global standard, a statistically weak significant difference was confirmed between the B1 and the B0 groups, which is meaningful in the area of p-value less than 10% (p=0.052.) For the A1 and the B0 groups, as seen in the domestic standard, a statistically significant difference was confirmed.

Although these are the results of simple tests, it is confirmed that the strength of enforced discipline by institutional investors at the same time with supplementally strengthened governance has a positive effect on corporate value.

Figure 12　PBRs by Group Classified with Institutional Investor Ratio and GR Scores



Source: Prepared by Nikko Research Center

Appendix 1　The Evaluation Items of the GR Scores 2020

No	Themes	Evaluation items	Domestic	Global
1	Board role and responsibilities	The role and responsibilities of the board	○	○
2		Multiple directorships	○	○
3		Voting results	○	-
4		Shareholder engagement: opponents	○	-
5		Shareholder engagement: policies	○	-
6		Shareholder engagement: agendas	○	-
7	Leadership and independence	Board independence	○	○
8		Lead independent director	○	○
9		Effectiveness of the board	○	○
10		Criteria for independence	○	○
11		Regular meetings consisting solely of independent directors	○	○
12		The role and responsibilities of independent directors	○	-
13		Committees or advisory committees	○	-
14	Composition and appointment	Board composition	○	○
15		Board diversity	○	○
16		Director tenure	-	○
17		Directors nomination process	○	○
18		Board evaluations	○	○
19		Nomination committee	○	○
20		CEO succession planning	○	-
21	Corporate culture	Bribery and corruption	-	○
22		Whistleblowing	○	○
23		Code of conduct	○	○
24	Risk oversight	Proactive oversight	-	○
25		Risk culture	-	○
26		Risk committee	-	○
27	Remuneration	Alignment with performance	○	○
28		Executive directors' long-term incentive plan		○
29		Remuneration reporting		○
30		Business results and potential risks	○	○
31		Remuneration of NEDs	-	○
32		Remuneration committee	○	○
33	Reporting and audit	Non-financial information	○	○
34		Audit committee	-	○
35		Audit lotation	-	○
36		Shareholder approval of auditor appointment	-	○
37	Shareholder meetings	Proxy statement	○	○
38		Voting procedures	○	○
39	Shareholder rights	Equality and redress	○	○
40		Anti-takeover defense	○	○
41		Equity capital	○	○
42		Conflict of interests	-	○
43		Related party transactions	○	○
44		Cross-shareholdings: disclosure of the cross-shareholdings policies	○	-
45		Cross-shareholdings: Preventing from selling cross-shares	○	-
46	Composition and appointment	CEO dismissal	○	-

Appendix 2　Descriptive Statistics of Overall Scores of GR Scores for Four Years

Domestic	# of samples	mean	median	standard error	minimum	maximum
GR2017	100	48.5	50.0	12.7	20	77
GR2018	100	51.4	53.0	12.7	20	77
GR2019	108	50.9	53.5	12.3	20	76
GR2020	111	54.2	56.0	12.0	23	80

Global	# of samples	mean	median	standard error	minimum	maximum
GR2017	100	20.9	20.0	7.2	5	42
GR2018	100	22.1	21.0	7.2	6	50
GR2019	108	23.7	24.5	7.2	4	40
GR2020	111	25.5	25.0	7.9	6	46

[End]

Chapter 2 Governance Status of the 111 companies with GR Scores

1. The Board of Directors

1.1. Global Standard and Japanese Companies' Board of Directors

At a stock company, the shareholders must appoint directors, and the directors appointed by the shareholders must endeavor to maximize corporate value. The board of directors needs to be formed optimally by determining what type of form the board should be, through the selections including the number of directors and their experience and skills structure, and the matters to be resolved or delegated for execution towards corporate value maximization.

The global standard separates the management oversight and execution and urges that the board of directors with a majority of independent directors representing shareholders oversee the business execution. Because of the economic background, only the directors in an independent position can properly monitor business execution. Besides, for the board of directors to make better decisions, it believes (1) Nomination and Remuneration Committees, (2) Independent board of directors' chairperson, (3) Diversity, (4) Lead independent Outside Director, and (5) Executive sessions are necessary.

On the other hand, historically in Japan, the board of directors has been comprised mainly of internal directors, and many of them have engaged in business executions. The following section examines the boards of directors' structures at the 111 companies analyzed in the GR Scores 2020 while compared them with the global standard.

1.2. The Board of Directors Composition

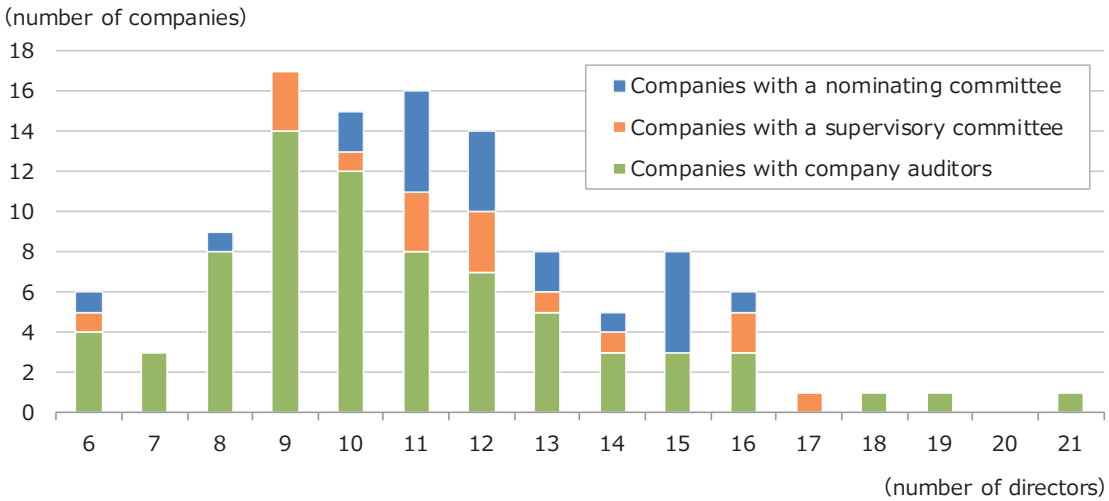
1.2.1. Board of Directors Forms and Number of Directors

The breakdown of the board of directors' forms at the 111 companies is as follows: 73 (65.8%) with company auditors, 22 (19.8%) with nominating committee, etc., and 16 (14.4%) with supervisory committee. Adopting the board of directors' form is basically at each company's discretion, and we do not judge which one is superior.

The average number of board members at the 111 companies is 11.2 (median 11.0 and mode 9.0), with a minimum of six at six companies; Shionogi, Shiseido, Renesas Electronics, HOYA, Canon, and Unicharm, while the maximum of 21 at Shin-Etsu Chemical. The range between nine and twelve directors accounts for 56% (see Figure 13.)

The average number of directors by the board of directors' form are as follows: 12.2 (median 12.0) at companies with a nominating committee, etc., 11.8 (median 11.5) at companies with a supervisory committee, and 10.8 (median 10.0) at companies with company auditors. As mentioned below, at the 22 companies with a nominating committee, etc., independent directors comprise a majority of the board. However, because of the proportionate number of internal directors they also have, the board of directors' scale is not small at many companies.

Figure 13 Distribution Chart of the Number of Directors at the 111 Companies



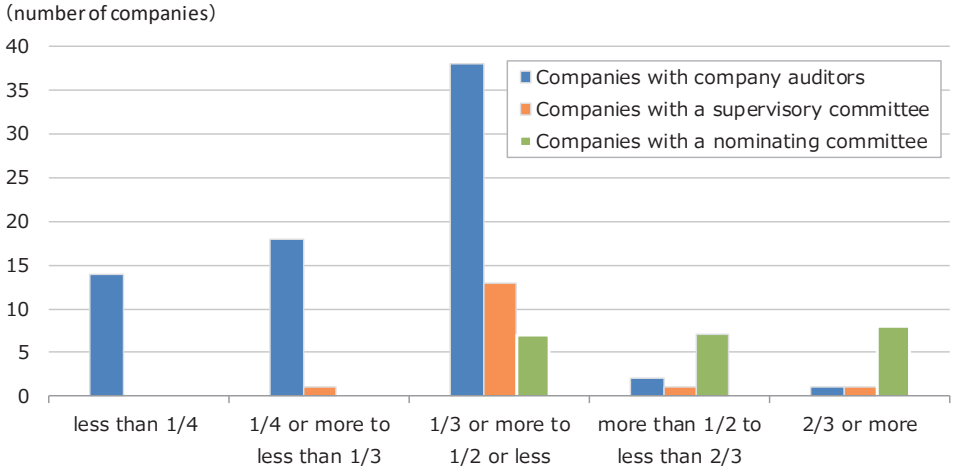
Source: Prepared by Nikko Research Center

1.2.2. Outside Director Ratio to the Board of Directors

The average composition rate of outside directors on the board of directors at the 111 companies is 39.4%. By board of directors' form, the rate is 60.9% at the companies with a nominating committee, etc., 40.9% at the companies with a supervisory committee, and 32.6% at the companies with company auditors. The highest rate of outside directors of the 111 companies is 83.3% at Toshiba and HOYA; both are the companies with a nominating committee, etc.

The companies with a nominating committee, etc. must establish three committees (nominations, remuneration, and audit) with a majority of outside directors for the purpose of segregating management and business execution. At 15 out of 22 such companies, the outside directors account for a majority of the board. The outside director ratio is less than 50% at the remaining seven companies, but no company has a ratio less than one-third (see Figure 14.)

Figure 14　Outside Director Ratio by the Board of Directors' Form



Source: Prepared by Nikko Research Center

The companies with a supervisory committee's outside director ratios are concentrated in a range between one third or more and one half or less, with 13 out of 16 companies in the range. For the companies with company auditors, the outside director ratios in the range between one third or more and one half or less account for 52.1%, while the ranges between one quarter and more and less than one third, and less than a quarter account for 24.7% and 19.2% respectively, indicating proportionate number of companies.

The board of directors at Takeda Pharmaceutical and Astellas Pharma, the companies with a supervisory committee, and Renesas Electronics, Rakuten, and Fast Retailing, the companies with company auditors, comprise a majority of outside directors.

Japan's Corporate Governance Code recommends appointing at least two independent directors on the board of directors. From that perspective, all the 111 companies fulfill the condition. Meanwhile, the ICGN Global Governance Principles suggests that the board of a widely-held company should comprise a majority of independent non-executive directors. As mentioned above, we believe that business executions properly overseen by independent non-executive directors who comprise a majority of the board result in superior decision-making and increased corporate value.

Therefore, the foreign institutional investors expect a higher external director ratio at Japanese companies. However, in most cases, they have yet to demand a global standard level. For example, foreign institutional investors, including CalPERS, a major US pension fund, sent letters to the companies in its investment portfolio in 2017, requesting the board of directors comprised of one-third or more outside directors.

CalPERS requires at least one-third of outside directors because although one-third is not the level at which the outside directors can proactively engage in the management's decision-making, they believe the level has certain influence when internal directors have split opinions.

Of the 111 companies, 78 companies' board of directors consists of one-third or more outside directors, fulfilling the level required by CalPERS. Besides, 20 companies among them have a majority of outside directors, also fulfilling the global standard.

1.2.3. Appointment of Non-independent directors

Domestic institutional investors have a strong tendency to disapprove of the appointment of non-independent directors. Even if a company argues that the outside director candidate is independent, they carefully review the candidate's background and oppose when the candidate does not meet their standards. Besides, even when independent directors account for a majority of the board, domestic institutional investors have different views, and the consensus that they do not require further independence has yet to be established.

Of the 111 companies, nine companies have appointed non-independent directors who do not meet their independence standards. Since the GR Scores 2020 evaluates based on the data disclosed by the end of December 2019, the approval rate for the non-independent directors (eleven) at the shareholders meetings of the nine companies held immediately before the date was low at 80.0% on average. Among them, the approval rate was in the 70% range at four companies and in the 60% range at two companies.

Therefore, when non-independent directors' approval rate is low, the companies need to disclose why they select the candidates as outside directors and what roles they expect such candidates to play.

1.2.4. Who Chairs the Board of Directors

The board of directors of the 111 companies is chaired by the company chairperson at 45.9%, by the president at 41.4%, by the outside director at 10.8%, and by the inside director other than the company chairperson or the president at 1.8% (see Figure 15.) By the board of directors' form, the rate of the board chaired by an outside director is relatively high at the companies with a nominating committee, etc., and even if chaired by the company chairperson, the person does not have the right to represent. An outside director chairs the board also at companies with a supervisory committee and companies with company auditors, although in a few cases.

Figure 15　Composition Ratio of the Board of Directors Chairperson

		Company chairperson			President	Outside director	Inside director other than the company president or the president
			Have the right to represent	Not have the right to represent			
Total	number of companies (111)	45.9%	24.3%	21.6%	41.4%	10.8%	1.8%
Companies with a nominating committee	(22)	27.3%	0.0%	27.3%	31.8%	36.4%	4.5%
Companies with a supervisory committee	(16)	37.5%	25.0%	12.5%	56.3%	6.3%	0.0%
Companies with company auditors	(73)	53.4%	31.5%	21.9%	41.1%	4.1%	1.4%

Source: Prepared by Nikko Research Center

The ICGN Global Governance Principles stipulate, "The board should be chaired by an independent non-executive director. There should be a clear division of responsibilities between the role of the chair of the board and executive management." The Principles give first priority to secure the board of directors' independence, requiring an independent chairperson even under the situations where the board comprises a majority of independent non-executive directors.

Meanwhile, Japan's Corporate Governance Code does not describe who should chair the board. The president or the company chairperson has often chaired the board of directors traditionally in Japanese companies. At 73 of 111 companies, the president or the company chairperson with the right to represent chairs the board of directors. Moreover, even when the company chairperson without the right to represent (at 24 companies) or the inside director other than the company chairperson or the president (at two companies) chairs the board, the cases that disclose the division of responsibilities with the management (such as the description that the chairperson of the board does not engage in business execution) stays around half at about 54%.

Under such circumstances, seven of the 111 companies met the global standard, with the board of directors comprises a majority of independent directors and also chaired by an independent outside director.

1.2.5. Disclosure on the Number of Directorships Capable for a Director to Undertake

The ICGN Global Governance Principles stipulate that the degree to which each individual director has the capacity to undertake multiple directorships should be clearly disclosed. The Principles also state that normally, an individual director should not hold more than 3 or 4 directorships of any sort, and this should be substantially

less for a director with executive responsibilities, as well as for the board chairman and key committee chairs.

Meanwhile, Japan's Corporate Governance Code states that the capacity of directors including outside directors to undertake multiple directorships should be limited to a reasonable range, but it does not suggest a specific number of directorships to be undertaken. Therefore, many 111 companies describe that the number of directorships to be undertaken "should be in the reasonable range."

Only five (4.5%) of the 111 companies specifically disclose the number of directorships capable for a director. The one company of five limits the number of permissible directorships to three, the three companies limit it to four, and another one rules it with one for internal director and three for outside directors. However, no company restricts the number taking the roles of board chairman and key committee chairs into account, as stated in the ICGN Global Governance Principles.

1.2.6. Conclusion

The global standard separates the management oversight and execution and urges that the board of directors with a majority of independent directors representing shareholders oversee the business execution. Meanwhile, historically in Japan, the board of directors has been comprised mainly of internal directors, and many of them have engaged in business executions. At many companies with a nominating committee, etc. of the 111 companies, the board of directors comprises a majority of outside directors, but the cases are lower at companies with a supervisory committee and companies with company auditors. At 20 of the 111 companies, the majority of the board of directors are outside directors, satisfying the global standard.

In terms of the board of directors' chairperson, the global standard stipulates that the chair should be independent even for the board comprises a majority of independent non-executive directors to secure the board of directors' independence. Against this purpose, the president or the company chairperson with the right to represent chairs the board of directors at 66% of the 111 companies.

1.3. Female Directors

1.3.1. Movements Seeking Female Director Appointments

As for the female directors, the ICGN Global Governance Principles include gender in diversity, stipulating that the board should disclose its policy on diversity (including gender, ethnicity, cognitive and social.) Besides, Japan's Corporate Governance Code describes, "The board should be well balanced in knowledge, experience and skills to

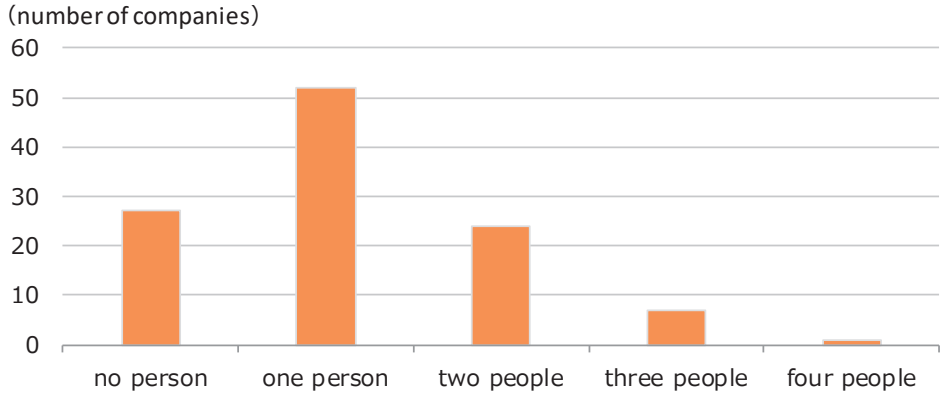
fulfill its roles and responsibilities, and it should be constituted in a manner to achieve both diversity, including gender and international experience, and appropriate size," encouraging female director appointments as part of diversity.

Although the causal relationship of positive effects on corporate performance by having female director on the board of directors has yet to identify, many studies suggest that the performance of the companies with female director on the board is relatively superior. For this reason, CalPERS has traditionally carried out engagement asking for female director appointments to the companies which have no female director. The U.S. BlackRock has been recommending to the companies in its investment portfolio to appoint two or more female directors since 2018. Furthermore, Goldman Sachs Asset Management has recently changed its voting standards to oppose the nomination committee or the top management, if not such committee, when there is no female director on the board also for Japan's companies.

1.3.2. Number of Female Directors

The number of female directors in the 111 company is 1.1 on average. Sony has the most with four female directors, followed by three at seven companies, two at 24 companies, one at 52 companies, and zero at 27 companies (see Figure 16.)

Figure 16　No. of Female Director at the 111 Companies



Source: Prepared by Nikko Research Center

By the board of directors' form, the rate of the companies with two or more female directors is the highest at companies with a nominating committee, etc., and the rate for one or zero is the highest at companies with company auditors (see Figure 17.) By

the ratio of female directors to the board of directors, the ratio of more than 10% female director is the highest also at companies with a nominating committee, etc., while the rate of 10% or less is the highest at companies with company auditors. Meanwhile, among the companies with company auditors, Shiseido and Renesas Electronics' board of directors comprises more than 30% female directors (two out of six directors at both companies.)

Figure 17　No. and Rate of Female Directors by Board of Directors' Form

Number of female director		no person	one person	two people	three people	four people
Total	number of companies (111)	27	52	24	7	1
Companies with a nominating committee	(22)	1	8	7	5	1
Companies with a supervisory committee	(16)	3	7	4	2	0
Companies with company auditors	(73)	23	37	13	0	0

Ratio of female directors to the board of directors		0%	more than 0% to 10% or less	more than 10% to 20% or less	more than 20% to 30% or less	more than 30%
Total	number of companies (111)	27	37	37	7	3
Companies with a nominating committee	(22)	1	6	11	3	1
Companies with a supervisory committee	(16)	3	5	7	1	0
Companies with company auditors	(73)	23	26	19	3	2

Source: Prepared by Nikko Research Center

1.3.3. Skills and Expertise of Female Directors

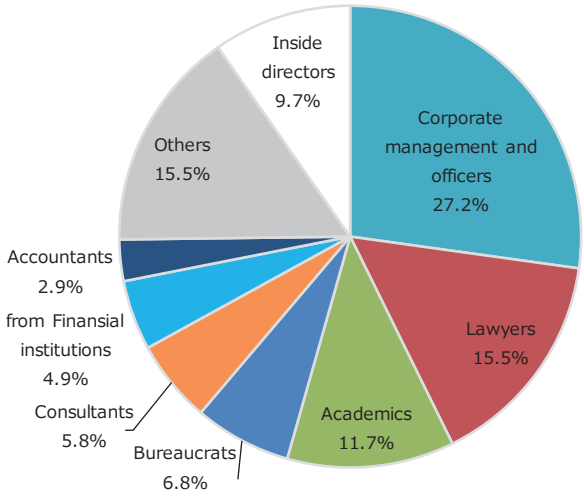
The number of female directors of the 111 companies is 125 including duplication and 103 excluding duplication. Figure 18 shows the classification of the 103 female directors' skills and expertise. Note that Nikko Research Center limited the number of careers to one when the director has multiple careers, by reference to the roles expected as a director described in the notice of convocation and each career's length.

As careers of 103 female directors, the corporate management and officers, whom monitoring the board of directors is also expected, are the highest at 27.2%. Some have experienced officers' roles at major domestic or overseas companies, while some are the representative directors of the company they have launched themselves.

Moreover, the careers other than internal directors are well varied: 15.5% are lawyers,

11.7% are academics, 6.8% are bureaucrats, 5.8% are consultants, 4.9% are from financial institutions, and 2.9% are accountants.

Figure 18　Skills and Expertise of the 103 Female Directors at the 111 Companies



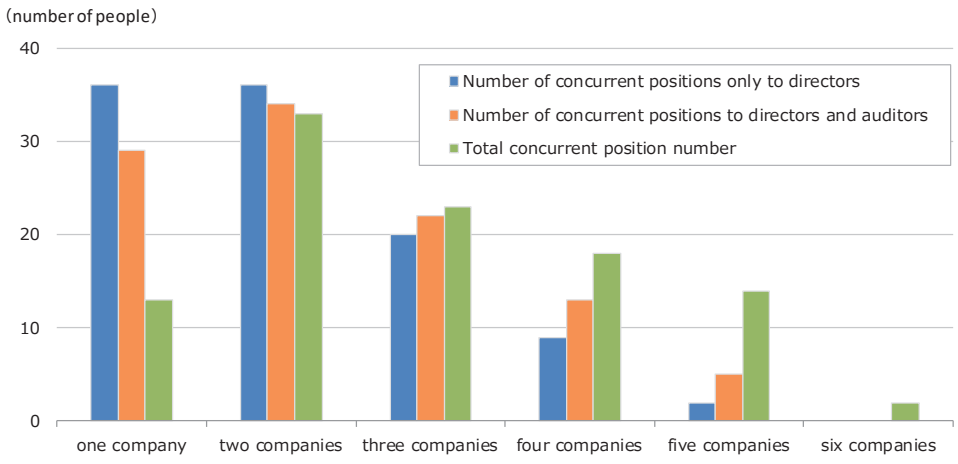
Source: Prepared by Nikko Research Center

1.3.4. Number of Directorships the Female Directors Hold

The total number of positions the 103 female directors concurrently hold is 2.9 on average. The total concurrent position number of two is the most with 33 persons (32.0%), followed by three with 23 persons (22.3%), and four with 18 persons (17.5%), accounting for a considerable rate. Thirteen persons have one directorship, of which seven are internal directors and six are outside directors (see Figure 19.)

When narrowing down the number of 103 female directors' number of concurrent positions only to directors, they have positions at 2.1 companies on average. The positions held at two companies and one company account highly for 35.0% respectively. The rate of one company relative to the total concurrent position number is high since 23 persons have two or more concurrent positions but only one directorship. Although 11 persons (10.7%) concurrently serve as directors for four or more companies, it suggests that female directorship has diversified to some degree.

Figure 19　No. of Positions the Female Directors of the 111 Companies Concurrently Hold



Source: Prepared by Nikko Research Center

1.3.5. Conclusion

Many studies suggest that the performance of the companies with female director on the board of directors is relatively superior. For this reason, CalPERS and BlackRock have traditionally carried out engagement asking for female director appointments to the companies in their investment portfolios. Also, Goldman Sachs Asset Management has recently changed its voting standards to oppose the appointment of directors when there is no female director on the board of directors, also for Japan's companies.

Since 76% of the 111 companies appoint one or more female directors, the companies with no female directors are in the minority. As skills and expertise of female directors of the 111 companies, the corporate management and officers account for the largest portion, whom monitoring the board of directors is also expected. However, the careers vary, including lawyer, academic, and bureaucrat.

1.4. Lead Independent Outside Director, Executive Session, and the Board of Directors Evaluation

1.4.1. Presence of Lead Independent Outside Director

The ICGN Global Governance Principles stipulate that the board of directors should appoint a lead independent director, whom such roles as (1) providing shareholders and directors with a valuable channel of communication should they wish to discuss concerns relating to the chair, and (2) evaluating the board of directors chair, are

expected. In other words, the Principles believe that the monitoring of the board of directors led by the lead independent outside director would result in optimal operation of the board.

Meanwhile, Japan's Corporate Governance Code refers to the appointment of the lead independent outside director in the Supplementary Principle 4.8.2, as one of the measures for independent directors to establish a framework for communicating with the management and cooperating with auditors or the auditors' board. However, it does not necessarily recommend an appointment of the lead independent outside director. Of the 111 companies, only eight (7.2%) appoint the lead independent outside director and disclose who the lead outside director is distinctively.

Of the eight companies appointing the lead independent outside director, five are the companies with a nominating committee, etc., which appoint 6.8 independent directors on average. Three are the companies with company auditors, which appoint 3.0 independent directors on average. Accordingly, regardless of the board of directors' form and the number of independent directors, the companies that recognize the needs for lead independent outside director appoint well-qualified person and expect the person to play the roles.

1.4.2. Executive Sessions

The ICGN Global Governance Principles claim that the non-executive directors should meet at least annually without the chair present (executive session) hosted by the lead independent director. One of the critical purposes of holding an executive session is evaluating the chair by outside directors. In the United States, where the CEO often chairs the board of directors, the New York Stock Exchange listing criteria mandate to hold the executive sessions, attempting to prevent the control over the board of directors by the CEO.

Japan's Corporate Governance Code also recommends regular meetings consisting solely of independent directors in the Supplementary Principle 4.8.1. Consequently, 38 of the 111 companies disclose that they hold meetings comprised exclusively of independent directors. The Code specifies the purpose of the meeting is that independent directors exchange information and develop a shared awareness from an independent and objective standpoint to contribute to discussions at the board actively. Therefore, many of the 38 companies design similar goals. Of them, some cite strengthening oversight of business execution and discussion on corporate governance, but none of them specify the evaluation of the board of directors' chairperson.

1.4.3. Effectiveness Evaluation of the Board of Directors

(1)Disclosure of Effectiveness Evaluation of the Board of Directors

As for the board of directors' evaluation, the ICGN Global Governance Principles insist that the board should rigorously evaluate the performance of itself, the board's committees, and individual directors prior to being proposed for re-election. The purpose is to figure out the board of directors' actual status and recommend appointments or reappointments of directors led by the nomination committee, considering (1) whether each director's contributions deserve reappointment, and (2) if the board consists of sufficient skills and experience compared to the structure thought optimal.

Japan's Corporate Governance Code stipulates in Principle 4.11 and Supplementary Principle 4.11.3 that the board of directors should analyze and evaluate its effectiveness each year and disclose a summary of the results. Its nuance is different from what the global standard require in that it focuses on promoting disclosure of the analysis and evaluation of whether the board of directors effectively functions.

(2)Disclosure on the Board of Directors Effectiveness Evaluation at the 111 Companies

Of the 111 companies, 104 companies (93.7%) disclose the Board of Directors effectiveness evaluation results in accordance with Japan's Corporate Governance Code. Of the seven that do not disclose the results, five companies do not have any description that can be regarded pertinent to analysis and evaluation, even if they have items of effectiveness analysis and evaluation in their disclosures including corporate governance reports. Each one of the rests does not describe the most recent fiscal year's evaluation results or passes on a description of the relevant fiscal year mainly due to a misconduct of business, respectively.

As for the contents of the board of directors effectiveness analysis and evaluation, while some companies are targeting satisfactory disclosure with the idea of factual analysis and evaluation, at 31 companies (42.5%) of 104 companies, the contents lack the objective elements and are limited to subjective descriptions only, showing a massive difference in ranges among the companies.

(3)Characteristic Disclosures of the Board of Directors Effectiveness Evaluation

The examples of the characteristic disclosure of the board of directors effectiveness evaluation of the 104 companies are as follows: Kao and Eisai disclose the evaluations with abundant and detailed descriptions against their evaluation axis, showing

relatively vigorous attitudes for disclosure of current issues and the direction towards future initiatives externally.

SMC Corporation, SUBARU CORPORATION, and Nitori Holdings disclose the charts showing the scoring questionnaire results by item of the board of directors' effectiveness evaluation. It tells externally what kind of challenges they are aware of.

In evaluating the board of directors' effectiveness, not a few companies use third-party agencies for preparation and tallying questionnaires, interviews with directors, and the evaluation process itself. Among such companies, Sony, in addition to the above, described that its third-party agency (1) reviewed the board of directors' minutes, and sat with the directors at the board, and (2) compared its evaluation with other Japanese and Euro-American global corporations, disclosing relatively advanced approach to the use of third-party agency.

1.4.4. Conclusion

The global standard recommends an appointment of a lead independent outside director and believes that evaluating the board of directors' chair by the executive session hosted by the lead independent outside director optimally operates the board of directors. Especially when the CEO chairs, the executive session works to prevent the board of directors from being controlled by the CEO. Meanwhile, most 111 companies have not appointed the lead independent outside director under the present circumstances.

From the global perspective, the purpose of the board of directors evaluation is to recommend appointments and reappointments of directors led by the nomination committee, considering (1) whether each director's contributions deserve for reappointment, and (2) if the board consists of sufficient skills and experience compared to the structure thought optimal. In contrast, Japan's Corporate Governance Code focuses on analyzing and evaluating whether the board of directors effectively functions. Therefore, the 111 companies often describe in their disclosures the ideas and challenges to let the board of directors work effectively.

1.5. Roundup

The global standard separates the management oversight and execution and urges that the board of directors with a majority of independent directors representing shareholders oversee the business execution. Besides, for the board of directors to make better decisions, it believes (1) Nomination and remuneration committees, (2) Independent board of directors' chairperson, (3) Diversity, (4) Lead independent

outside director, and (5) Executive sessions are necessary.

Meanwhile, historically in Japan, the board of directors has been comprised mainly of internal directors, and many of them have engaged in business executions. Concerning the 111 companies, 70% of their board of directors comprise one-third or more outside directors, of which 20 companies' board also fulfill the global standard with a majority of outside directors.

In terms of the board of directors' chairperson, the global standard stipulates that the chair should be independent even for the board comprises a majority of independent non-executive directors to secure the board of directors' independence. Against this purpose, the president or the company chairperson with the right to represent chairs the board of directors at many of the 111 companies.

From the diversity perspective, many studies suggest that the performance of the companies with female director on the board is relatively superior. Since 76% of the 111 companies appoint one or more female directors, the companies with no female directors are in the minority. As skills and expertise of female directors of the 111 companies, the corporate management and officers account for the largest portion, whom monitoring the board of directors is also expected. However, the careers vary, including lawyer, academic, and bureaucrat.

The global standard recommends an appointment of a lead independent outside director and believes that evaluating the board of directors' chair by the executive session hosted by the lead independent outside director optimally operates the board of directors. Especially when the CEO chairs, the executive session works to prevent the board of directors from being controlled by the CEO. Meanwhile, most 111 companies have not appointed the lead independent outside director under the present circumstances.

From the global perspective, the purpose of the board of directors evaluation is to recommend appointments and reappointments of directors led by the nomination committee, considering (1) whether each director's contributions deserve for reappointment, and (2) if the board consists of sufficient skills and experience compared to the structure thought optimal. In contrast, the disclosures of such items at the 111 companies focus on analyzing and evaluating whether the board of directors effectively functions in accordance with Japan's Corporate Governance Code.

[End]

2. The Committees

2.1. The Ways Nomination Committee and Remuneration Committee Should Be

The purpose of establishing a nomination committee and a remuneration committee in corporate governance is to strengthen the independence, objectivity, and accountability of board functions regarding nomination and remuneration.

To this end, the ICGN Global Governance Principles stipulate that the board should establish a nomination committee and a remuneration committee comprised of a majority of independent non-executive directors to seek appropriate involvement and advice. Besides, some companies with advanced corporate governance rule that all the committees' members should be independent directors to secure the board of directors' independence and objectivity.

However, some Japanese companies show the recognition that the management should appoint directors and fix their remuneration, possibly raising questions from the independence and objectivity perspectives in some cases. The followings are the elaborations on the nomination committee and remuneration committee at the 111 companies we analyzed in the GR Scores 2020, mainly from the independence perspective.

2.2. Status of Nomination Committee and Remuneration Committee

2.2.1. Establishment and the Number of the Committee Members

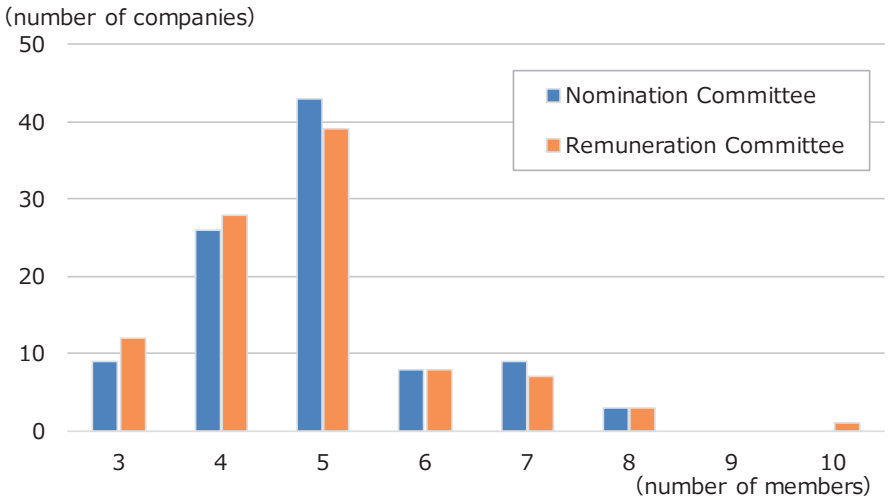
As for the establishment of the nomination committee and remuneration committee at the 111 companies, both committees have been established at 63 (out of 73) companies with company auditors, and at 13 (out of 16) companies with a supervisory committee, for both the establishment is left to their option, and at 22 (out of 22) companies with a nominating committee, etc., at which the establishment is mandatory. Accordingly, 98 companies in total have established the nomination committee and remuneration committee.

The number of the nomination committee members is 4.9 on average of the 98 companies, with a minimum of three at nine companies and a maximum of eight at three companies. The number of the remuneration committee members is 4.8 on average of the 98 companies, with a minimum of three at 12 companies and a maximum of ten (at Kao only). Kao's remuneration committee comprises seven directors (of which four are outside directors) out of eight directors from the board of directors and three outside auditors. In many cases, the number of members in both committees is four to five, meaning they are similar in scales (see Figure 20.)

Moreover, given the establishing purpose of committees to strengthen the board of

directors' function, it is raison d'être, the reason for existence, of the committee whether the nomination committee and remuneration committee make decisions. The committees established with an even number of members do not seem likely to be premised to make decisions delegated by the board of directors. A considerable number of the 111 companies, i.e., 37 companies' nomination committees and 40 companies' remuneration committees are with even number of members.

Figure 20　No. of Members in Nomination Committee and Remuneration Committee



Source: Prepared by Nikko Research Center

2.2.2. The Reasons for Not Establishing Nomination Committee and Remuneration Committee

In the Supplementary Principle 4.10.1., Japan's Corporate Governance Code mentions that if the independent directors do not compose a majority of the board, the company should establish independent advisory committees such as the nomination committee and the remuneration committee comprised mainly of the independent directors. Of the 111 companies, 13 companies have not established either committee. As the reason for not establishing the advisory committees such as nomination committee and remuneration committee, 11 of the 13 companies often explain that independence, objectivity, and accountability of the board functions are secured as they receive appropriate involvement and advice from outside directors.

However, of the 13 companies that have not established either committee, no company was found to have their board of directors comprised of a majority of

independent directors. From the transparency standpoint of nomination and remuneration processes, it, if at all, could hardly be said accountable without committees. Besides, suppose if the management's proposal had some issues, when the number of independent directors on the board is small, it could not be duly examined.

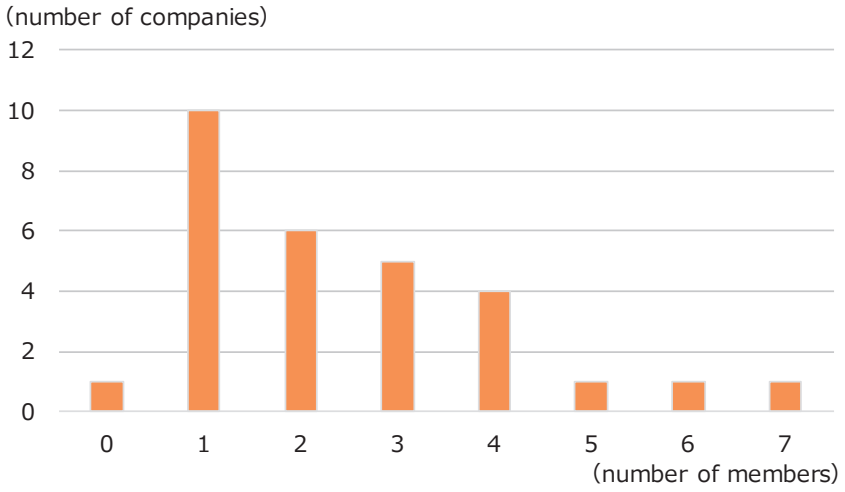
2.2.3. Cases where Members Concurrently Serve for Both Committees

Under Japan's Companies Act, a company with a nominating committee, etc., is mandated to establish a nomination committee and a remuneration committee comprised of a majority of outside directors, and the committees' decisions are legally binding. In contrast, at a company with company auditors and a company with a supervisory committee, the committee's establishment is left to the company's option. Therefore, the Act does not mention details about the framework of whether to establish one advisory committee formally, combining a nomination committee and a remuneration committee, or establish both committees separately.

Since both committees sometimes discuss based on the board of directors' evaluation, we believe it is rational to establish a committee as a unified one, and all the members concurrently serve for both committees to share the contents of the nomination and remuneration committees' discussion. However, the expertise and roles required for members of the nomination committee and the remuneration committee essentially differ. Even if both committees are formally established as a unified one or separately, it is a heavy burden for the members to serve for both committees concurrently, possibly raising questions whether they can carry through the required roles.

Of the 111 companies, 30 companies establish both committees as a unified advisory committee formally, and 68 companies establish both separately. Of the 68 that establish both committees separately, all the members concurrently serve both committees at 31 companies. Although they set the nomination committee and the remuneration committee separately, both committees are regarded virtually as a unified one. In analyzing the number of members serving concurrently for both committees except for the cases where all the members serve both, one member serving both was most (at ten companies) while no member works for both at one company (see Figure 21.) Moreover, eight companies have not disclosed the committee members. Thus, the status of serving both committees remains unclear.

Figure 21　No. of Members Serving Concurrently for Both Committees

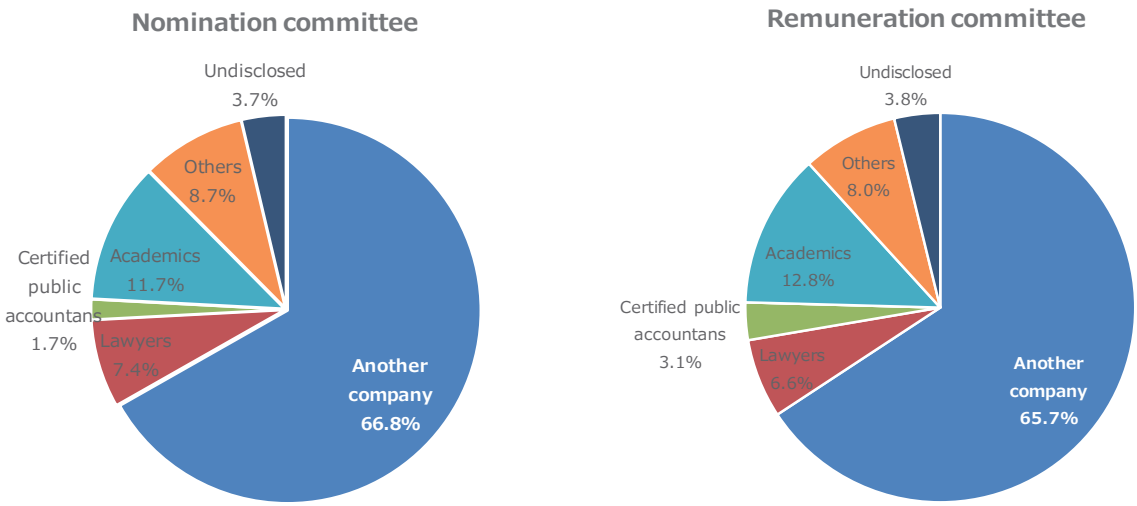


Source: Prepared by Nikko Research Center

2.2.4. Attribution of the Outside Directors

There is no significant difference in outside directors' attribution between the nomination committee and the remuneration committee at the 111 companies. In terms of attribution, most outside directors were previously with another company, which account for 66.8% at the nomination committee and 65.7% at the remuneration committee. The second most was academic, accounting for 11.7% at the nomination committee and 12.8% at the remuneration committee, followed by others, lawyers, and certified public accountants. As a breakdown for others, the survey found quite a few attributions considered to fall under former national public officers, such as former diplomats and former bureaucrats. Note that we classified the cases as "undisclosed" if there was no description of the committee members and the attribution of outside directors in the committees were unclear (see Figure 22.)

Figure 22　Attributions of Outside Directors



Source: Prepared by Nikko Research Center

There is no significant difference in both committees because, as mentioned in 2.2.3, the members concurrently serve for both committees in many cases. Once again, the expertise and roles required for members of the nomination committee and the remuneration committee essentially differ. For instance, the members of the nomination committee should be the person who understands what skills the board of directors is in short of, what skills they require for the next directors and what the company's board of directors needs in light of the business environment in which the company is located, and should be able to take inventory of skill set. We believe that the company should examine its outside directors whether they have the expertise to carry through these roles in light of their experience from their background.

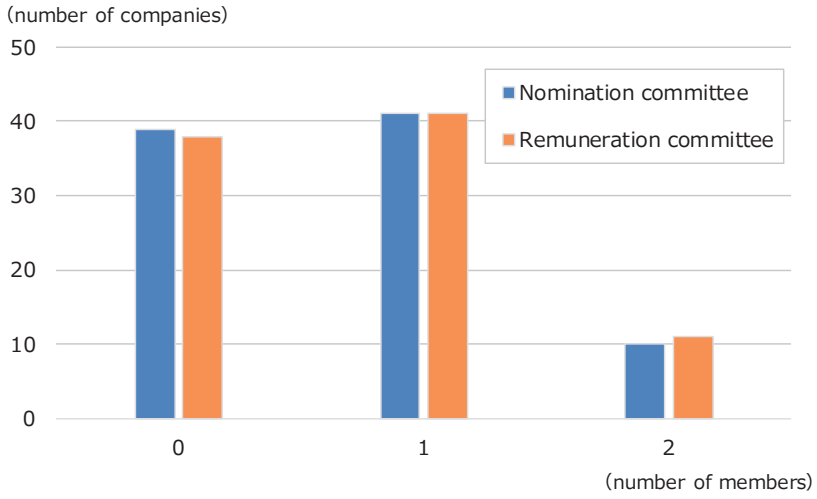
2.2.5. No. of Female Members in the Nomination and Remuneration Committees

Many studies show the positive results of the relationship of having female director on the board and the corporate performance. In contrast, there are not many studies on female directors in the nomination committee and the remuneration committee. However, we believe that having female director not only on the board of directors but also in the committees would bring diversity to the committees and thus, lead to secure diversity in the board of directors.

At the nomination committee and the remuneration committee of the 111 companies, there is no significant difference in the number of female committee

members since the members concurrently serve for both committees in many cases, as mentioned in 2.2.4. Forty-one companies appoint one woman each for nomination and remuneration committees. Ten companies for their nomination committee and 11 companies for their remuneration committee appoint two women, respectively. Meanwhile, 39 companies' nomination committee and 38 companies' remuneration committee have no female member (see Figure 23.) Given that 84 companies (75.7%) of the 111 companies have appointed female directors[7], the companies that appoint female directors as members for each of the committees are relatively few. Although most female committee members are outside directors, there was the case where the remuneration committee elected two female outside auditors and one female external expert as members. Since the eight companies have not disclosed the committee members, female members' presence could not be confirmed.

Figure 23　No. of Nomination and Remuneration Committees' Female Members



Source: Prepared by Nikko Research Center

2.3. Roles of the Nomination Committee and the Remuneration Committee

2.3.1. Roles of the Nomination Committee

The nomination committee's primary role is to appoint or reappoint directors to compose an independent board of directors. The critical element in playing the role is the independence of the committee. To establish an independent board of directors, the nomination committee itself, which recommends appointments or reappointments

7　Refer to 1.3. Female Directors.

of directors, must be independent.

The subsequent role of the nomination committee includes evaluation of the board of directors' composition. While taking diversity policy into account, the committee members should evaluate whether the board of directors' composition is optimal from the perspective of improving corporate value and monitoring. These evaluations enable the nomination committee to clarify the improvements, develop directors' succession plan, and examine the next directors' appointments or reappointments.

Furthermore, directors' succession planning is also a critical role of the nomination committee. Japan's Corporate Governance Code contains a description of a succession plan for the CEO, but not for directors. However, for the board of directors to keep functioning optimally, not only the CEO's succession plan but also the directors' succession plan would be necessary.

2.3.2. Roles of the Remuneration Committee

The remuneration committee's primary role is to develop a remuneration policy and recommend it to the board of directors. In developing a remuneration policy, the committee members should evaluate whether the policy is designed to motivate the achievement of long-term management objectives and improvements in corporate value, share the interest with shareholders, and not to take excessive risks. The committee itself must be independent to perform these roles by having outside directors who represent shareholders in the committee. In short, independence is necessary from the perspective of sharing interests with shareholders.

The remuneration committee's subsequent role includes developing, implementing, evaluating, and monitoring the remuneration plan. The committee members should not only design and implement the remuneration plan but also assess whether the paid remunerations were appropriate. These evaluations and monitoring enable the remuneration committee to determine the necessity of revised payment by examining whether the remuneration under the business environment and evaluation based on performance are reasonable.

2.3.3. The Roles Required for Both Committees by the Global Standard

The primary role in common for both committees is to monitor conflict of interest. Identifying and avoiding conflict of interest among committee members and between committees and their advisors are crucial to observe the board of directors' independence principles.

The subsequent role of both committees includes the appointment of an outside

consultant. It is not easy to decide what the nomination and remuneration policies should be from the perspective of improving corporate value. Therefore, the companies generally use outside consultants by the global standard, and it is believed beneficial to bring them in to enhance transparency of nomination and remuneration processes. When adopting an outside consultant, the conflict of interest mentioned above could be the issue. Therefore, in selecting outside consultant, the independent committee, not internal departments, should appoint the independent consultant.

Dialogue with shareholders directly or through the board of directors is also an important role. On rare occasions, the companies communicate to shareholders what was discussed at the committees through integrated reports. However, only a few companies in Japan likely recognize it as a role of committees.

2.3.4. Descriptions of the Roles at the 111 Companies given GR Scores

We believe that all of the roles mentioned above only work when the committees are independent. Therefore, we only evaluate the descriptions on the roles of the companies that fulfilled the global standard in terms of the committee composition in the GR Scores 2020. The evaluations based on the global standard mentioned in this report are the ones comprised of non-executive directors and a majority of the members are independent for the nomination committees, and the ones consisting of a majority of independent non-executive directors for the remuneration committee.

As a result of analysis based on the above standards, the companies whose committee composition meet the global standard are 16 companies for the nomination committee and 65 companies for the remuneration committee. There are 15 companies whose nomination committee recommends the nomination, appointment, and reappointment of directors upon its composition has met the global standard. Only Bridgestone evaluates the board of directors, only Takeda Pharmaceutical Company develops directors' succession plan, and only Japan Post Insurance monitors the conflict of interest. No description was found on an outside consultant's appointment and dialogue with shareholders (see Figure 24.)

Figure 24　Description of the Nomination Committee Roles in the GR Scores 2020

	number of companies
Recommending nomination, appointment, and reappointment of directors	15
Evaluating the composition of the board	1
Developing director succession planning	1
Monitoring of conflict of interest	1
Appointing consultants for recruitment or evaluation and disclosing their identity and consulting fees	0
Entering into dialogue with shareholders on the subject of board nominations	0

Source: Prepared by Nikko Research Center

Forty-nine companies set the remuneration policy and recommend it to the board of directors upon fulfilling the global standard. Meanwhile, the number of companies developing, implementing, evaluating, and monitoring the stock compensation and other benefit plans stays low at 14. No description was found on monitoring of conflict of interest, the appointment of an outside consultant, and dialogue with shareholders (see Figure 25.)

Figure 25　Description of the Remuneration Committee Roles in the GR Scores 2020

	number of companies
Determining and recommending to the board the company's remuneration policy	49
Designing, implementing, monitoring and evaluating short-term and longterm share-based incentives and other benefits schemes including pension arrangements	14
Monitoring of conflict of interest	0
Appointing remuneration consultant and disclosing their identity and consulting fees	0
Entering into dialogue with shareholders on the subject of remuneration	0

Source: Prepared by Nikko Research Center

2.4. Independence the Nomination Committee and the Remuneration Committee

As mentioned in 2.3.4, the committee's independence is an essential issue for the committees to play the roles. We examine hereunder the committee composition of the 111 companies on the following three points, (1) independent outside director rate, (2) attribution of the committee, and (3) presence of the president or the company chairperson, from the independence perspective. Moreover, as mentioned in 2.2.1, since the committees established with an even number of members do not seem

likely to be premised to make decisions delegated by the board of directors, we exclude them from the examination. Thus, the companies whose committees are with an odd number of members, i.e., 61 companies for the nomination committee and 58 companies for the remuneration committee, are subject to our analysis.

As for (1) Independent outside director rate, the ICGN Global Governance Principles also require the committees' independence. The independent directors are indispensable to receive advice on nomination and remuneration from an independent viewpoint. For the completely independent committees, the following (2) and (3) do not matter.

As for (2) Attribution of the committee, the committee's independence and objectivity would be strengthened by having an independent outside director chair the committee, lead the discussion, and elicit the outside directors' autonomous engagement. In contrast, if the management, such as the company chairperson with the right to represent or the president, lead the discussion, it could cause the committee to become a mere facade where the decision is made with prioritized internal logic. Therefore, it would be preferable that the independent outside director chairs the committee.

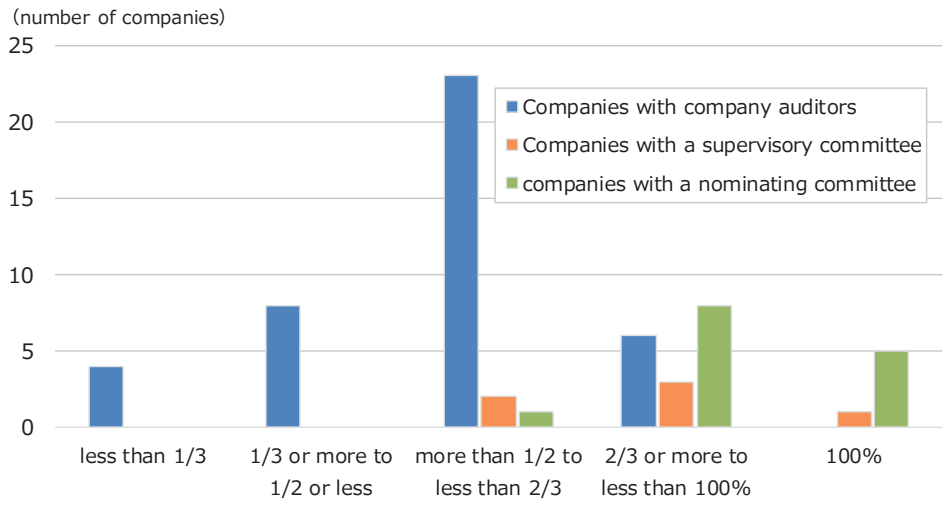
As for (3) Presence of the president or company chairperson, if the management which is well versed in the internal information participated in the committee, it could be rational, but it could lead to being self-righteous to have the management with the right to represent, which is considered a strong power in it. The measures such as exclusion from the committee and request participation as needed, or composition of highly independent committee even when having the management in it and letting them leave the venue while the committee deliberates the evaluation of the management, would be necessary.

2.4.1. Independence of the Nomination Committee

(1)Independent outside director rate

Forty-nine of the 111 companies have the nomination committee in which independent directors account for more than 50%. Of which, 14 are the companies with a nominating committee, etc., six are the companies with a supervisory committee, and 29 are the companies with company auditors. The independent director rate is high at the companies with a nominating committee, etc., as they are obliged to have a majority of outside directors in the committee. There are six companies whose committee members are all independent directors, of which five are the companies with a nominating committee, etc. Meanwhile, 12 companies' independent outside director rates are 50% or less, and all of them are the companies with company auditor (see Figure 26.)

Figure 26　Independent outside director rate in the Nomination Committee

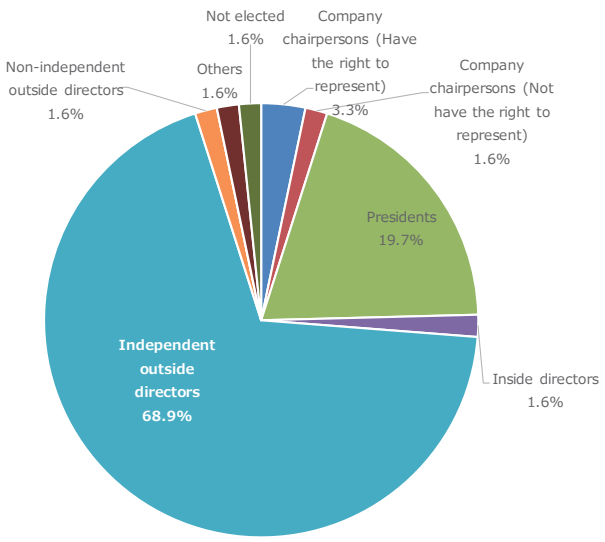


Source: Prepared by Nikko Research Center

(2)Attribution of the Committee Chairperson

At the 111 companies, the rate of nomination committee chaired by an independent outside director is the highest at 68.9% (42 companies.) The committee chaired by the president follow at 19.7% (12 companies) (see Figure 27.) Meanwhile, at three companies, the independent director rate in the nomination committee is less than 50%, and the company chairperson with the right to represent or the president chairs the committee.

Figure 27　Attribution of the Nomination Committee Chairperson

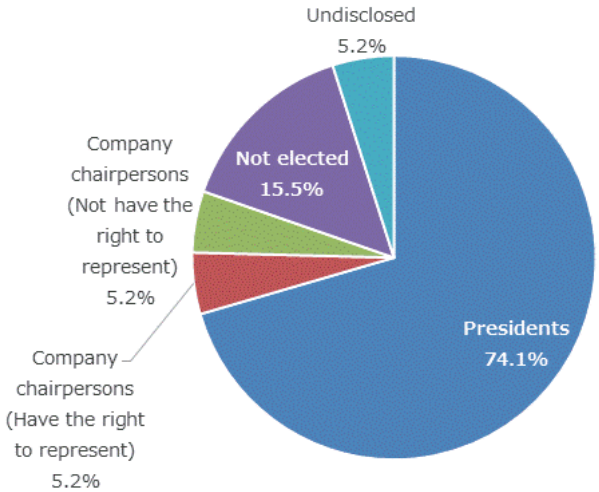


Source: Prepared by Nikko Research Center

(3)Presence of the President or the Company Chairperson

Of the 111 companies, 74.1% (43 companies) include the president in the nomination committee. At 5.2% (three companies), the company chairperson with the right to represent is contained even when the committee does not include the president in the members. Meanwhile, 15.5% (nine companies) do not have the president and the company chairperson in their nomination committee (see Figure 28.)

Figure 28 Presence of the President or Company Chairperson in the Nomination Committee



(Notes) If both the president and chairperson are included in the committee, counted it as a case where the president is included.

(Notes) If the president is not but the chairperson is included in the committee, counted it as a case where the chairperson is included.

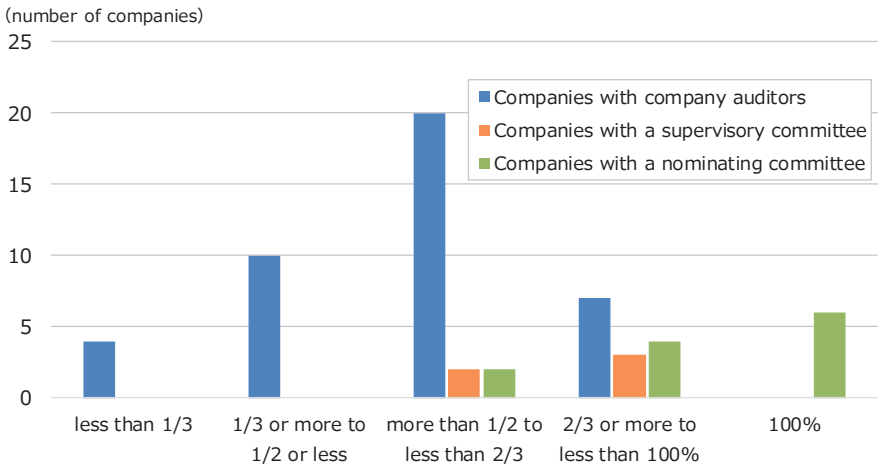
Source: Prepared by Nikko Research Center

2.4.2. Independence of the Remuneration Committee

(1)Independent outside director rate

There were 44 companies of the 111 companies with the remuneration committee in which independent directors account for more than 50%. Of these, 12 are the companies with a nominating committee, etc., five are the companies with a supervisory committee, and 27 are the companies with company auditors. Same with the nomination committee, the independent director rate is high at the companies with a nominating committee, etc., as they are obliged to have a majority of outside directors also in the remuneration committee. There are six companies whose committee members are all independent directors, and all of them are the companies with a nominating committee, etc. Meanwhile, 14 companies' independent outside director rate is 50% or less, and all of them are the companies with company auditor (see Figure 29.)

Figure 29　Independent outside director rate in the Remuneration Committee

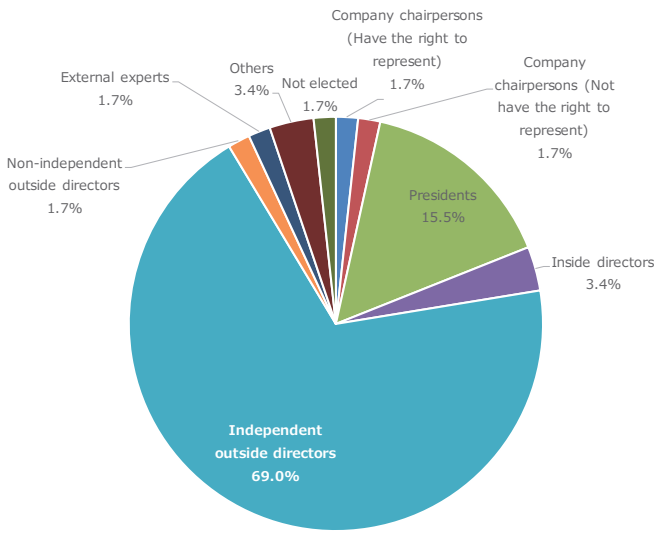


Source: Prepared by Nikko Research Center

(2)Attribution of the Committee Chairperson

At the 111 companies, as well as the nomination committee, the rate of remuneration committee chaired by an independent director is the highest at 69% (40 companies.) The committee chaired by the president follow at 15.5% (nine companies) (see Figure 30.) Meanwhile, at two companies among the 111 companies, the independent director rate in the remuneration committee is less than 50%, and the company chairperson with the right to represent or the president chairs the committee.

Figure 30　Attribution of the Remuneration Committee Chairperson

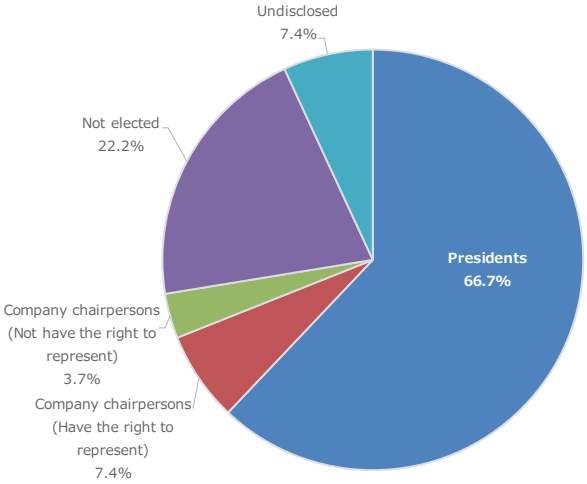


Source: Prepared by Nikko Research Center

(3)Presence of the President or the Company Chairperson

Of the 111 companies, 66.7% (36 companies) include the president in the remuneration committee. At 7.4% (four companies), the company chairperson with the right to represent is contained even when the committee does not include the president in the members. Meanwhile, 22.2% (12 companies) do not have the president and the company chairperson in their remuneration committee (see Figure 31.)

Figure 31　Presence of the President or the Company Chairperson in the Remuneration Committee



(Notes) If both the president and chairperson are included in the committee, counted it as a case where the president is included.

(Notes) If the president is not but the chairperson is included in the committee, counted it as a case where the chairperson is included.

Source: Prepared by Nikko Research Center

2.5. Conclusion

Of the 111 companies, 98 companies have established the nomination and remuneration committees, indicating that most companies have set up both committees. However, there is no significant difference in the committee composition, including the number of members, the attribution of outside directors, and the number of female members between the nomination committee and the remuneration committee. It made clear that the members often serve concurrently for both committees. Besides, though the committees established with an even number of members could raise the question of whether they are premised to make decisions, it revealed that the considerable number of the companies, 37 companies for nomination

committee and 40 companies for remuneration committee, have their committee in such form.

As for the roles of the nomination and remuneration committees, some companies describe them, but no description of the common roles for both committees, i.e., monitoring of conflict of interest, the appointment of an outside consultant, and dialogue with shareholders (except for one company describing monitoring of conflict of interest as a role of the nomination committee) was found. It is therefore likely that those roles are not recognized as both committees' at this stage.

The roles of the nomination and remuneration committees only work when the committees are independent. As for the nomination and remuneration committees' independence, 49 companies' nomination committees and 44 companies' remuneration committees comprise an odd number of members as decision-making bodies, and the independent director rate is more than 50%. It shows that quite a few companies have one or two independent committees. Moreover, the independent director serves as the committee chair in many cases. A considerable number of companies, 43 and 36 appoint the president as a member of the nomination and the remuneration committee, respectively. Some companies with advanced corporate governance rule that all the committees' members should be independent directors to secure the board of directors' independence and objectivity. The independent director rate, the committee chairperson's attribution, and the presence of the president or company chairperson do not matter in such completely independent committees, making it easy for them to be appraised from outside from a transparency perspective of nomination and remuneration processes.

[End]

3. Remuneration

3.1. Roles of the Management Remuneration in Corporate Governance

In corporate governance, the management remuneration aligns the interests of the management and shareholders, and at the same time, plays the role of a "carrot" that motivates the management to expand the corporate value.

The ICGN Global Governance Principles stipulate that "Remuneration should be designed to effectively align the interests of the CEO and executive officers with those of the company and its shareholders to help ensure long-term performance and sustainable value creation." Japan's Corporate Governance Code explains that the remuneration of the management "should include incentives such that it reflects mid to long-term business results and potential risks, as well as promotes healthy entrepreneurship." There is no difference between the global standard and Japan's Code in that both recommend the management remuneration designed to improve corporate value over the mid to long-term.

3.2. Disclosure on the Management Remuneration

3.2.1. Management Remuneration Structure

The ICGN Global Governance Principles stipulate that "Remuneration should be structured in a simple manner and balance salary levels appropriately in comparison with the level of benefits such as bonuses, deferred stock options or long-term incentive plans." Besides, Japan's Corporate Governance Code explains about the management remuneration that "The proportion of management remuneration linked to mid to long-term results and the balance of cash and stock should be set appropriately." Both require the introduction of mid to long-term incentives in the structure of the management remuneration.

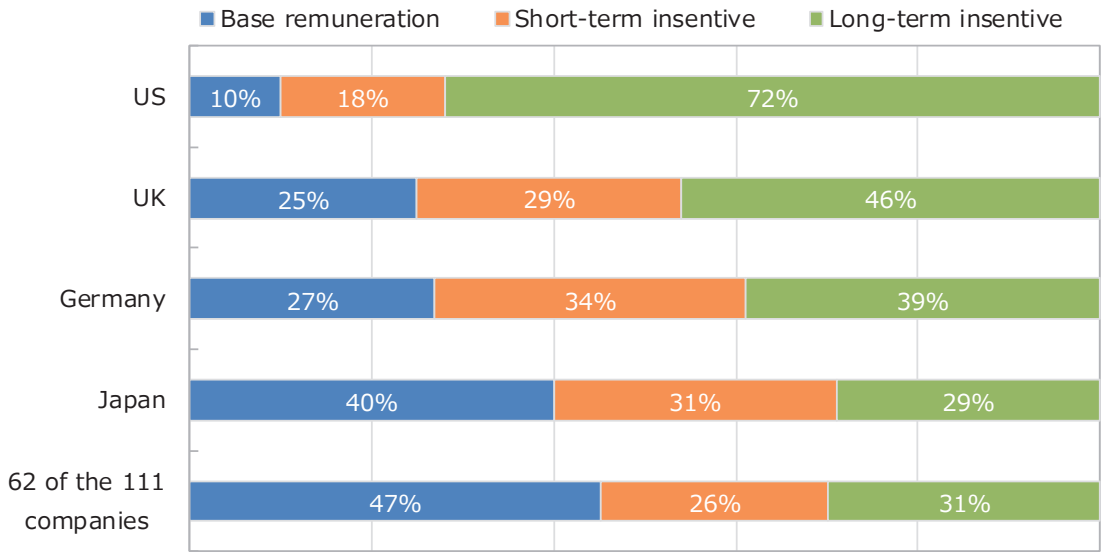
In light of the above, we checked the disclosures of 111 companies whether they (1) have introduced long-term incentives, and (2) describe the specific remuneration ratio and the upper limits of each type of remuneration. The result is that 65 companies' (59%) disclosure fulfill these two criteria.

Sixty-two companies of the above 65 companies disclose specifically the structure of base remuneration, short-term incentives, and long-term incentives. The breakdown of the 62 companies' management remuneration on average is as follows: 47% (median 50%) of base remuneration, 26% (median 25%) of short-term incentives, and 31% (median 30%) of long-term incentives (add up to more than 100% as some companies disclose only a part of those ratios.) It shows that nearly half of the management remuneration is base remuneration, and some halves of the rest are short- and long-

term incentives.

The comparison of the CEO remuneration in Western countries and Japan[8] shows the rate of base remuneration in CEO remuneration is high at 40% in Japan, compared to 10% in the U.S., 25% in the U.K., 27% in Germany (see Figure 32.) As the GR Scores examine the overall management remuneration structure, the basis is different from the above data. As such, the result shows that the 62 companies' base remuneration rate is about seven points higher than the above figure of Japan. Under such circumstances, seven of the 62 companies set the base remuneration rate at or under 30%, having designed the plan with strong incentive in which the management remuneration and business performance link as highly as Western companies. In contrast, the base remuneration comprises 70% or more of the management remuneration at six companies.

Figure 32　Structure of CEO and the Management Remuneration by Country



(Note 1) Based on Willis Towers Watson's data for the U.S., the U.K., Germany and Japan

(Note 2) The U.S., the U.K., Germany and Japan are for CEO remuneration of the companies with 1 trillion yen or more revenue

Source: Prepared by Nikko Research Center based on materials from Willis Towers Watson and each company

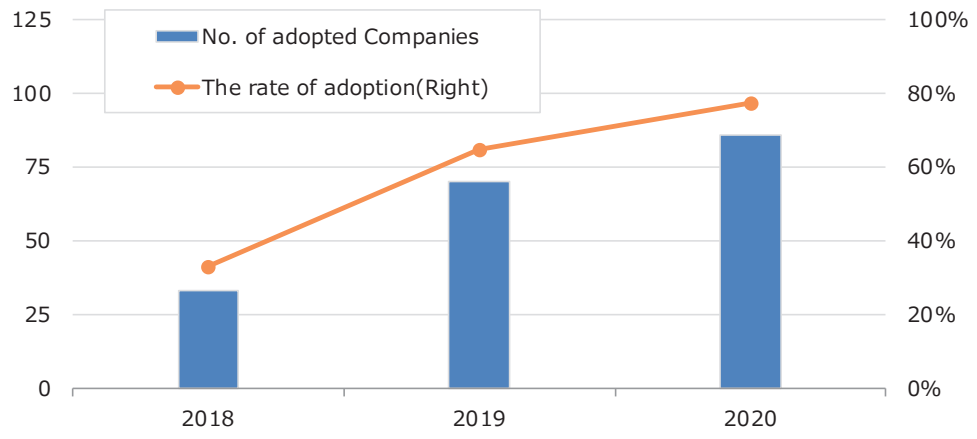
8 Willis Towers Watson announced the FY2020 survey results of "CEO compensation comparisons in five developed countries" on July 29, 2020.
https://www.willistowerswatson.com/ja-JP/News/2020/07/report-fy2019-japan-us-europe-ceo-compensation-comparison

3.2.2. Adoption of Restricted Stock

As for the performance-linked incentive methodologies, the ICGN Global Governance Principles states that "The use of restricted stock with long-term vesting and holding periods brings the benefit of simplicity compared with metric-based performance awards." Therefore, the Principles recommend introducing restricted stock alongside the metric-based performance awards, or by itself.

Eighty-six (77%) among the 111 companies have adopted the restricted stock awards system including BIP (Board Incentive Plan) trust and stock ownership plan trust, or the system practically equal to the restricted stock awards such as stock option that cannot exercise the right during the term of office. The rate of adoption was only 33% in the GR Scores 2018, but increased significantly to 65% in the GR Scores 2019, then further extended in the GR Scores 2020 (see Figure 33.)

Figure 33　No. of Companies Adopting Restricted Stock Awards



Source: Prepared by Nikko Research Center

In the background of increased adoption of the restricted stock awards is that, most significantly, the tax reform in 2016 has included the restricted stock fulfilling certain requirements in the fixed compensation notified in advance, makes it a deductible expenses under the Corporation Tax Act. Besides, a further recommendation of the management remuneration system with incentives in Japan's Corporate Governance Code also likely to influence.

3.2.3. Design of Incentive Remuneration

In addition to the 65 companies that disclose its adoption of long-term incentive and its rate to overall remuneration, 42 companies disclose its adoption of short-term incentive only or do not disclose the long-term incentive rate even if they have adopted it. Adding these, 107 (96%) of the 111 companies have adopted the mechanism that links the management remuneration and its business performance.

Regarding what kind of indicators and remuneration are linked in designing incentives for management remuneration, 94 (84%) of the 107 companies disclose the indexes, including performance index. It revealed that the companies often use the indexes related to profitability, such as current operating profit (at 49 companies), current net profit (at 43 companies), and ROE (at 26 companies.)

In addition to the performance indexes, eight companies include ESG indexes and non-financial indexes in the targets. Asahi Group Holdings, Kao, and Shiseido, three of these companies, disclosed that they use external or internal ESG indexes to evaluate social value. In particular, Kao specifically mentioned the use of Ethisphere Institute's (USA) "World's Most Ethical Companies." Mitsubishi Chemical Holdings has introduced MOS (Management of Sustainability) as one of the performance evaluation indices and incorporates the descriptions, including reducing environmental impact, contributing to health and medical care, compliance, and preventing accidents and fires in its report. Besides, West Japan Railway explains that its performance evaluation indicators contain the element of ensuring railway safety.

In disclosing how the management remuneration and business performances are linked, not a few companies only mention that they simply link it to the gauges such as operating profit, but 23 of the 94 companies refer to how they link current term performance to management remuneration concretely. Among them, nine companies deserve high marks in that they also have explained the relevance of mid to long-term corporate objectives and management remunerations. Furthermore, two companies, Astellas Pharma and Nidec Corporation, disclosed the indicators they use when granting long-term incentive and their evaluation weights, specific targets of the indicators, the fluctuation range of evaluation coefficient according to the achievement rate of the targets in their annual securities reports comprehensibly.

3.2.4. Other Disclosures that the Global Standard Requires for Management Remuneration

The ICGN Global Governance Principles requires disclosure of management remuneration, including anti-fraud measures for the management, remuneration

policy for non-executive directors, and remuneration reports.

First, intending to prevent serious misconduct by the management and a material misstatement in its financial statements, the ICGN Global Governance Principles recommend incorporating a malus or a clawback clause. The malus is a clause to withhold the payment of any sum in the event of serious misconduct or a material misstatement in the company's financial statements, and the clawback clause is to recover sums paid. Of the 111 companies, 29 companies (26%) disclose that they have adopted these clauses. The Japanese companies, incorporating clawback clause especially in the remuneration system, are on the rise.

Secondly, as for non-executive directors (NED) pay, the ICGN Global Governance Principles stipulate that it "should be structured in a way which ensures independence, objectivity and alignment with shareholders' interests" and "Performance-based pay should not be granted."

Of the 111 companies, 95 companies (85%) disclose that they do not grant performance-based pay to NED, indicating that most companies pay fixed remuneration only. Meanwhile, four companies have adopted the stock remuneration system also for NED, intending to align the interests with shareholders.

The opinions divide globally whether to grant stock remuneration to NED. The U.S. prefers granting stock remuneration, while Europe, especially the U.K., tend to prefer fixed pay.

Lastly, in Japan, the companies must disclose the director's name who received annual remuneration of 100 million yen or more and the amount they received individually. However, they are not required to reveal all directors' compensation. Therefore, none of the 111 companies disclosed the remuneration report in a form required by the global standard or in a similar way.

3.3. Conclusion

Most of the 111 companies disclose that they have adopted the performance-based incentive remuneration system, but the base remuneration rate is high relative to European and US companies. Meanwhile, following the tax reform and the revision of Japan's Corporate Governance Code, the companies adopting restricted stock as a performance-based incentive are rising.

In terms of what kind of indicators and remuneration are linked in designing incentive for management remuneration, many companies use profitability related indexes such as current operating profit, current net profit, and ROE. Meanwhile, though the number of the companies is small, some include ESG indexes and non-

financial indexes in targets.

In disclosing how the management remuneration and business performances are linked, not a few companies only mention that they simply link it to the gauges such as operating profit. Under the circumstances, Astellas Pharma and Nidec Corporation disclosed the indicators they use when granting long-term incentive and their evaluation weights, specific targets of the indicators, the fluctuation range of evaluation coefficient according to the achievement rate of the targets in their annual securities reports comprehensibly.

Concerning the management remuneration, the global standard also requires the disclosure of anti-fraud measures for the management and remuneration reports. From the perspective of anti-fraud measures for the management, companies among the 111 companies incorporating the clawback clause in the remuneration system are on the rise. Meanwhile, none of the 111 companies disclosed the remuneration report at the level required by the global standard.

[End]

4. Cross-shareholdings

4.1. Concept of Cross-shareholdings

The cross-shareholdings have the issues of "Hollowing out of Capital" from a capital efficiency perspective and "Hollowing out of Voting Right" from a corporate governance perspective. "Hollowing out of Capital" is to use business capital to hold other companies' shares for nominal reasons such as maintaining and strengthening business relationships, and not to invest in the businesses to expand profit growth. Moreover, "Hollowing out of Voting Right" means that the exercising voting rights by minority shareholders become a mere facade when a company (the management) maneuver for stable shareholders. With amicable and stable shareholders formed through cross-shareholdings, shareholder proposals are more likely to be rejected in exercising voting rights, while company proposals are more likely to be passed.

Especially, foreign investors have a critical view on cross-shareholdings from both capital efficiency and corporate governance perspectives. J.P. Morgan Asset Management states that "Due to potential conflict of interest, the risk of the proxy vote becoming inconsequential, and capital efficiency concerns, in general, we believe companies should not have cross-shareholdings in other companies[9]." The ICGN Global Governance Principles contain no principle regarding cross-shareholdings because currently, the cross-shareholdings rarely present a problem to European and US companies.

In contrast, Japan's Corporate Governance Code unsurprisingly denies cross-shareholdings as a maneuver for stable shareholders in the Principle 1.4, but requires the board to examine "whether the benefits and risks from each holding cover the company's cost of capital" from the viewpoint of capital efficiency. Originally, the cross-shareholdings are considered not reasonable against the cost of capital, but in this context, it could be interpreted that the reduction in holdings is not required when the benefits from holdings meet the cost of capital. However, the revision of Japan's Corporate Governance Code in 2018 added the description of disclosure of policies regarding the reduction of cross-shareholdings before the examination using a cost of capital, indirectly showing its position that the companies should not hold other listed companies' shares as cross-shareholdings.

9 J.P. Morgan Asset Management "Corporate Governance Policy & Voting Guidelines" https://am.jpmorgan.com/content/dam/jpm-am-aem/global/en/institutional/communications/lux-communication/corporate-governance-principles-and-voting-guidelines.pdf

4.2. Disclosures on Cross-shareholdings

4.2.1. Evaluation Items for Cross-shareholdings

We researched the 111 companies whether they disclose information on their cross-shareholdings in compliance with the Principle 1.4. Each company's information on cross-shareholdings are available in its annual securities report or corporate governance report. Note that the three companies, Japan Post Insurance, Komatsu, and Orix Corporation, which did not have cross-shareholdings, are evaluated as the companies compliant with the Code's principle.

(Item 1) "Whether the board annually examines each holdings by the cost of capital."

We studied the disclosures whether the examination on the rationality of cross-holdings is carried out "annually," "by the cost of capital," and "led by the board." It is because the Principle 1.4 requires examination by stating, "the board should annually assess whether or not to hold each individual cross-shareholding, specifically examining whether the purpose is appropriate and whether the benefits and risks from each holding cover the company's cost of capital."

(Item 2) "Whether the company discloses the policy regarding reduction of cross-shareholdings and its results."

The Principle 1.4 stipulates that "When companies hold shares of other listed companies as cross-shareholdings, they should disclose their policy with respect to doing so including their policies regarding the reduction of cross-shareholdings." Therefore, we researched whether the company discloses the policy regarding the reduction of cross-shareholdings and its results.

(Item 3) "Whether the company discloses that they would not hinder the sales of the cross held shares."

We consider that whether the company clearly demonstrates its intention not to hinder the reduction in cross-held shares at shareholders who hold the company's shares as cross-shareholdings or not is one of the measures that can assess the company's attitude toward cross-shareholdings. Therefore, we researched whether the company had disclosed that effect. Supplementary Principles 1.4.1 states that "When cross-shareholders (i.e., shareholders who hold a company's shares for the purpose of cross-shareholding) indicate their intention to sell their shares, companies should not hinder the sale of the cross-held shares by, for instance, implying a possible reduction

of business transactions."

4.2.2. Assessment Results

(Item 1) "Whether the board annually examines each holdings by the cost of capital."

It was learned that the board of directors of 50 (45%) of the 111 companies examine the economic rationality of cross-shareholdings by cost of capital annually. For the remaining 61 companies (55%,) i) could not confirm whether they use "cost of capital" in examining the economic rationality of cross-shareholdings at 35 companies (32%,) ii) the frequency of examination was unclear at 26 companies (23%,) and iii) the board's involvement in examination was unknown at 13 companies (12%.)[10] At the companies that do not mention the cost of capital, the disclosures are often abstract such as "we examine from a mid to long-term viewpoint" or "we examine from the perspective whether it contributes to improving corporate value."

Japan's Corporate Governance Code requires the companies to disclose whether they "Comply or Explain" each principle. Eight companies were confirmed not to comply with item 1 but explained its reason[11]. The eight companies are Daito Trust Construction, Nissan Motor, Shimano, Nintendo, Nomura Holdings, Tokio Marine Holdings, Central Japan Railway, and Nippon Telegraph and Telephone. For instance, Daito Trust Construction explains that they hold cross-shares when the two conditions, namely "rationality of holding purposes including business alliance, maintaining and strengthening transactions, and stabilization of shares," and "total assets on the consolidated balance sheet is 5% or less" are fulfilled.

(Item 2) "Whether the company discloses the policy regarding reduction of cross-shareholdings and its results."

Fifty-one (46%) of the 111 companies disclose the policy regarding the reduction of cross-shareholdings and its results. These 51 companies' reduction policies were mostly to "reduce when they recognize no significance in holdings" upon examining the cost of capital. In contrast, at most of the remaining 60 companies where disclosure could not be confirmed, the disclosures remain in the scope of holding policy of cross-shareholdings and examination methods of the shares held, without unveiling reduction policy.

(Item 3) "Whether the company discloses that they would not hinder the sales

10 The total is not 100%, since i) and ii) overlapped at 13 companies.

11 The companies that explained the reason are included in the 13 companies where i) and ii) overlapped since they did not disclose examination using cost of capital and the frequency of examination.

of the cross held shares."

There were 19 companies (17%) where we could confirm the disclosure that they would not hinder the sales of the cross-held shares against the holders.

Figure 34 Evaluation Results of the 111 Companies with GR Scores 2020

Item 1	Item 2	Item 3	Number of companies
○	○	○	5
○	○	×	23
○	×	○	3
○	×	×	19
×	○	○	7
×	○	×	16
×	×	○	4
×	×	×	34

Source: Prepared by Nikko Research Center

4.2.3. Best Practice of Disclosure: Fujitsu

Figure 34 shows the evaluation result that five companies' disclosures follow all the three items of the Principle 1.4 mentioned above. They are Ajinomoto, Toray Industries, Fujitsu, Sony Corporation, and Mitsubishi Heavy Industries.

Figure 35 shows the contents of each evaluation item disclosed by Fujitsu. The company mentioned that its board of directors annually assesses whether or not to hold each cross-shareholding using cost of capital and sell them sequentially when they recognize no significance in holdings. Furthermore, although the company sometimes set conditions on sales such as timing and method, it has demonstrated its intention not to hinder the sales of its cross-held shares. Fujitsu sold 78 issues of its cross-shareholdings in the amount of about 48.2 billion yen in FY2018.

Figure 35　Fujitsu's Disclosures

■Item 1 : Whether the board annually examines each holdings by the cost of capital.

The Company validates adequacy of strategic shareholdings at the Board of Directors Meeting every year, and continues to hold them when shareholdings are recognized as appropriate. The Board of Directors Meeting makes judgment on the strategic shareholdings in light of whether the purpose is appropriate and whether the benefits and risks from each holding cover the company's cost of capital, and other factors.

■Item 2 : Whether the company discloses the policy regarding reduction of cross-shareholdings and its results.

(Policy)

When no significance of shareholding in a positive manner can be recognized, the timing and method of selling those shares is examined, taking into account the scale of shareholdings, background of holding them, before selling them one by one to reduce

(Results)

For FY2018, the Company sold 78 issues, and the Board of Directors meeting, held on June 19, 2019, discussed strategic shareholdings held by the Company as of the end of March, FY2018.

■Item 3 : Whether the company discloses that they would not hinder the sales of the cross held shares.

Even when strategic shareholders indicate their sales of shares, we do not prevent them from selling them. Said that, we sometimes call upon them the timing of sales, or ways of selling them.

Source: Prepared by Nikko Research Center based on Fujitsu's "Corporate Governance Policy" and "Corporate Governance Report"

4.3. Status of Cross-shareholdings at the Companies with GR Scores 2020

Of the 111 companies 2020, 90 companies (including Japan Post Insurance, Komatsu, and Orix Corporation, which do not hold cross-shareholdings) announced FY2018 results after the revision of Cabinet Office Order on Disclosure of Corporate Affairs[12], made more specific information on cross-shareholdings available by descriptions in "Shareholdings" in the annual securities report. They handle the "Other than unlisted stocks" in the annual securities report as cross-shareholdings.

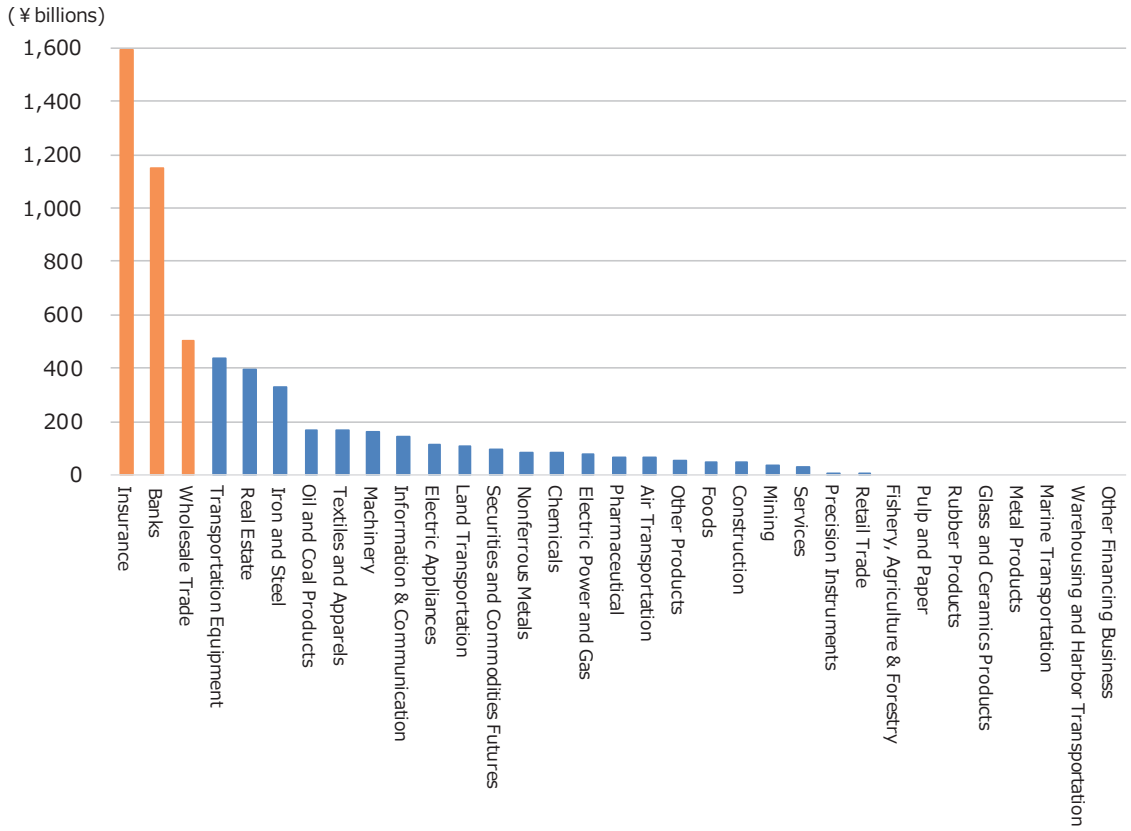
12 On January 31, 2019, Financial Services Agency revised part of the "Cabinet Office Order on Disclosure of Corporate Affairs (hereinafter "Cabinet Office Order.") It requires disclosures on cross-shareholding policy and assessment of its rationality. For individual issues, it also requires disclosure of quantitative holding effect associated with business details and segment information, the reason for increase in cross-shareholdings from the previous fiscal year, and whether the company holds cross-share or not. Besides, it is changed to disclose the number of issues of cross-shareholdings and the amount recorded on the balance sheet separately for listed and unlisted shares. Also, the coverage of holdings disclosed broadened to 60 issues from the previous 30 issues.

4.3.1. Status of Cross-shareholdings

The amount of cross-shareholdings held at the 87 companies excluding the three that do not own them totaled approximately to 25 trillion yen in FY2018, with a total sales amount of about 1.52 trillion yen and a total purchase amount of about 456.0 billion yen. Among the 87 companies, Mitsubishi UFJ Financial Group's holdings were the largest in terms of amount and the number of issues held, while Japan Post Bank had the least. Mitsubishi UFJ Financial Group[13] hold 1409 issues in the amount of about 4.13 trillion yen, while Japan Post Bank hold one issue of about 5 million yen. Mitsubishi UFJ Financial Group sold about 360 billion yen of cross-shareholdings in FY2018.

The average holding amounts of cross-shareholdings by industry were particularly high in the insurance, banking, and wholesale industries. As Figure 37 shows, the distribution of 87 companies' cross-shareholding amounts varies widely.

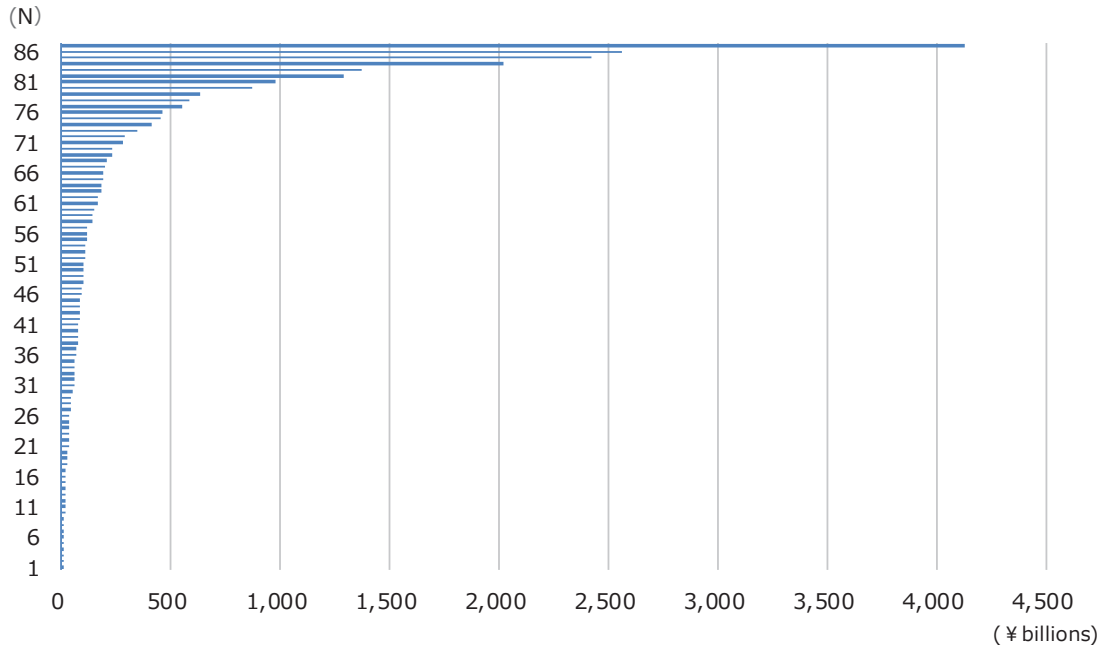
Figure 36　Average holding amount by TSE 33 Sectors



Source: Prepared by Nikko Research Center

13 Mitsubishi UFJ Financial Group is the holdings company and describes the status of cross-shareholdings of The Bank of Tokyo-Mitsubishi UFJ and Mitsubishi UFJ Trust, which are under the umbrella of the group.

Figure 37　Distribution of 87 Companies' Cross-shareholdings Amounts



Source: Prepared by Nikko Research Center

4.3.2. Sell-off of Cross-shareholdings

Fifty-three of the 87 companies with GR Scores 2020 reduced cross-shareholdings as their sales amount exceeded the purchase amount in FY2018[14]. Furthermore, nineteen of the 53 companies were confirmed to have only sold without buying additional cross-shareholdings.

Hitachi took the plunge and sold approximately 40 billion yen of its cross-shareholdings in FY2018 and did not buy any new cross-shareholdings in the same period. Hitachi revealed the seven issues it sold in FY2018 in its annual securities report. The seven companies were Japan Steel Works, Tohoku Electric Power, eREX, Nippon Telegraph and Telephone, Aeon, Toho Gas, and Kansai Electric Power. Hitachi had held each of them for business relationships, especially with supplier (Japan Steel Works), as an alliance partner (eREX), and as its customers with the remaining five companies.

Among the seven companies, Hitachi held the cross-shareholdings mutually with Toho Gas. While Hitachi sold off all shares of Toho Gas, its customer, in FY2018, Toho Gas reduced the holdings in Hitachi (from 192,620 shares to 38,534 shares) but did not wholly sell-off the equity. (As a reference, there were no changes of holding in Hitachi's shares in FY2019.)

14 Refer to appendix

However, the cross-shareholdings valued at market price brought a valuation loss (about 7%) as Hitachi's share price, 3,854 yen on March 30, 2018, was 3,585 yen on March 29, 2019. Therefore, it is highly likely that the companies would time the sell-off of cross-shareholdings.

We confirmed that while some of the companies with the GR Scores 2020 had decided to sell off the cross-shareholdings with valuation loss, some sold only the shares with valuation gains and suspended sell-off of the shares with valuation losses. Cross-shareholdings are the "Specified Securities[15]" and its four items, i.e., "Gain on Sales of Specified Securities," "Loss on Sales of Specified Securities," "Gain on Valuation of Specified Securities," and "Loss on Valuation of Specified Securities" are booked on profit and loss statements.

For example, Hitachi booked about 40.6 billion yen "**Gain on Sales** of Specified Securities" in FY2018, but did not book "**Loss on Sales** of Specified Securities." Besides, the company did not book any "**Gain on Valuation** of Specified Securities" but posted about 200 million yen of "**Loss on Valuation** of Specified Securities." It indicates that Hitachi sold cross-shareholdings issues with valuation gains only and decided to continue holding the issues that would cause losses on sales.

On the other hand, Mitsubishi Corporation, which sold about 82.3 billion yen of cross-shareholdings in FY2018, booked about 6.9 billion yen of "**Loss on Sales** of Specified Securities," indicating that it has started to sell-off the cross-shareholdings issues despite their valuation losses.

4.3.3. Inconsistency with Reduction Policy

We confirmed the cases where the purchase amount exceeded the sales amount at seven companies among the companies with GR Scores 2020 in FY2018, despite the reduction policy developed upon examining the economic rationality of cross-shareholdings as defined in Principle. The seven companies are Toray, SMC, Denso Corporation, FUJIFILM Holdings, Aisin Seiki, ANA HOLDINGS, and SoftBank. The survey found the case where the company not only bought the cross-shareholdings newly but also bought more of the issues the company already held. The key reasons for the increase in individual issues are maintaining and strengthening the business relationship, but some cases were also found where the shareholdings purchased by the supplier employee stock ownership association[16].

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15 The specified securities include the shares held solely for investment purposes other than cross-shareholdings. In FY2018, Hitachi did not hold any shares solely for investment purposes, and Mitsubishi Corporation did not book any losses on sales of shares held solely for investment purposes.

16 The supplier employee stock ownership association is a stock ownership association in which the employees acquire equities of the business associates to strengthen amity.

4.3.4. Possibility of Passive Sales

As mentioned above, sell-off activities of cross-shareholdings vary. However, as Miyajima and Kuroki (2007) and Tsumuraya (2020) noted, it is highly likely that the company which took action to secure liquidity on hand due to deteriorated business performance or financial condition sell off the cross-shareholdings. Moreover, the management may hope to cover the deteriorated performance of the core business with selling of cross-shareholdings to appeal to investors the stability of business performance. Indeed, the average amount sold at 36 companies (of 53) whose ROE deteriorated from the previous fiscal year was about 16.1 billion yen. In comparison, it was about 6.5 billion yen at 17 companies whose ROE stayed at the same level as the previous fiscal year or improved. Therefore, the possibility of passive cross-shareholdings sales cannot be ruled out instead of proactive reduction following the Corporate Governance Code principle.

4.4. Conclusion

Of the companies with GR Scores 2020, the companies that do not hold cross-shareholdings and compliant with the global standard are Japan Post Insurance, Komatsu, and Orix Corporation. Besides, 28 companies were confirmed to be following the Code's Principle by disclosing their reduction policy of cross-shareholdings and assessing whether or not to hold with the cost of capital. However, it was learned that the purchase amount of strategic shareholdings exceeded the sales amount at seven companies in FY2018, despite the disclosure of reduction policy. Although the extent of cross-shareholdings varies by sector, the research shows its overall declining trend.

(Appendix) Fifty-three Companies whose Cross-shareholdings' Sales Amount Exceeded Purchase Amount in FY2018

Securities code	Company Name	Securities code	Company Name
9531	TOKYO GAS	6753	**SHARP**
9503	**KANSAI ELECTRIC POWER**	6752	PANASONIC
9437	**NTT DOCOMO**	6702	FUJITSU
9432	NIPPON TELEGRAPH & TELEPHONE	6503	MITSUBISHI ELECTRIC
9020	EAST JAPAN RAILWAY	6501	**HITACHI,**
8802	MITSUBISHI ESTATE	6201	TOYOTA INDUSTRIES
8766	TOKIO MARINE HOLDINGS,	6098	**RECRUIT HOLDINGS**
8750	**DAI-ICHI LIFE HOLDINGS,**	5802	**SUMITOMO ELECTRIC INDUSTRIES,**
8725	MS&AD INSURANCE GROUP HOLDINGS	5411	JFE HOLDINGS,
8630	SOMPO HOLDINGS,	5401	**NIPPON STEEL**
8604	**NOMURA HOLDINGS**	5020	**JXTG HOLDINGS,**
8411	MIZUHO FINANCIAL GROUP,	4689	**Z HOLDINGS**
8316	SUMITOMO MITSUI FINANCIAL GROUP	4568	**DAIICHI SANKYO**
8309	SUMITOMO MITSUI TRUST HOLDINGS	4543	TERUMO
8306	MITSUBISHI UFJ FINANCIAL	4528	**ONO PHARMACEUTICAL**
8058	MITSUBISHI	4523	EISAI
8053	SUMITOMO	4507	**SHIONOGI**
8031	MITSUI	4502	TAKEDA PHARMACEUTICAL
7974	**NINTENDO**	4188	MITSUBISHI CHEMICAL HOLDINGS
7733	OLYMPUS	4063	SHIN-ETSU CHEMICAL
7270	**SUBARU**	3407	ASAHI KASEI
7269	**SUZUKI MOTOR**	2802	AJINOMOTO
7267	**HONDA MOTOR**	2269	MEIJI HOLDINGS
7203	TOYOTA MOTOR	2267	YAKULT HONSHA
7011	MITSUBISHI HEAVY INDUSTRIES,	1925	DAIWA HOUSE INDUSTRY
6981	MURATA MANUFACTURING	1878	**DAITO TRUST CONSTRUCTION**
6971	KYOCERA		

※ The companies in bold did not obtain any cross-shareholdings in FY2018.

Source: Prepared by Nikko Research Center

[End]

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