Minutes of the Second Council of Experts Concerning the Follow-Up of Market Restructuring

Date: Friday, September 9, 2022 14:30 – 16:10
Place: Tokyo Stock Exchange 15F Special Conference Room
Attendees: See member list (Mr. Kumagai and Mr. Koike were absent)

[Kikuchi, Director, Listing Department, TSE]
The time has now come to begin the second "Council of Experts Concerning the Follow-Up of Market Restructuring."
Thank you for joining us today.

First, regarding attendance, Mr. Kumagai and Mr. Koike cannot be with us today.

I would now like to move on to today's agenda, starting with an explanation by Mr. Ao.

[Ao, Senior Executive Officer, TSE]
During the first meeting, the TSE presented facts and data on the transition to the new market segmentation and the subsequent developments from a range of perspectives. Then you, the members, discussed how this council should move forward and the issues which still require follow-up, among other topics.

During the meeting, we received the feedback that we needed to sufficiently listen to the opinions of market players, including foreign investors. Therefore, we have invited market players as guests for today's meeting, and will ask for their opinions directly during our discussions.

We have invited Fidelity International and will be speaking with them today. JPX Market Innovation & Research, which calculates indices, is also participating.

Please note that this meeting is an occasion to follow up on market segmentation and the related listing rules. Concerning the topic of share indices, the Financial System Council's Expert Study Group on Capital Markets recommended in its 2019 report that the market operations and index calculation divisions be separated. In response to this finding, JPX Market Innovation & Research, an entity independent from the Tokyo Stock Exchange, has implemented index consultation and introduced an index advisory panel apart from this assembly, to take advantage of these activities to assess future developments.

During our previous meeting, we heard various takes regarding indices. For this reason, a manager from JPX Market Innovation & Research will explain the chronology and current situation. We hope to use the opinions we receive as future reference when JPX Market Innovation & Research will assess the modalities of indices.

Finally, we will sum up the opinions shared last time and hear any additional thought you might have.

This was the agenda for today.

[Kikuchi, Director, Listing Department, TSE]

Let's first hear from our guests.

From Fidelity International, Tetsuro Kubo, Officer, Head of Legal and Compliance, and Tomohiro Ikawa, Head of Engagement and Portfolio Manager, are with us today. Thank you for joining us.

[Fidelity International, Kubo, Officer, Head of Legal and Compliance]

Thank you for introducing me. I am Kubo, Officer and Head of Legal and Compliance at Fidelity International. Thank you for having me.

I'd like to thank you for this valuable opportunity. I guess many of you know about Fidelity International in some degree. We established our Japanese headquarters over 50 years ago, and we have been active for more than 30 years, after obtaining approval for the management of so-called investment trusts and discretionary investments. In Japan, we are particularly focused on Japanese stocks, and we have a dedicated management team for Japanese stocks at our Japanese headquarters. We have now become an active manager with a bottom-up approach and a global outlook, thanks to our collaboration with our global headquarters.

Today, I would like you to hear our company's thoughts regarding the follow-up on market restructuring, presented by Mr. Ikawa, Head of Engagement and Portfolio Manager at Fidelity International.

When it comes to Japanese stocks, our approach is 100% bottom-up. We start with research and, especially since the development of the Stewardship Code, we focus our efforts on engagement. This involves not only the engagement team, but also research analysts and portfolio managers, who all strive to engage with the companies we are investing in and the companies in which we plan to invest.

Mr. Ikawa will now start his explanation.

[Fidelity International, Ikawa, Head of Engagement and Portfolio Manager]

I am Ikawa from Fidelity International. I am in charge of stewardship issues and I mostly interact with companies on a regular basis. I would like to explain my concerns on market restructuring from a sustainability standpoint.

Starting on page 1, our current impression is that there has been a great acceleration of sustainability-related initiatives in Japanese companies, in the context of the revision of the Corporate Governance Code and the transition to new markets. However, as you can see, the gap with European companies is still wide. For instance, the graph on the left shows the trend in evaluations by ESG rating agencies. Japan is improving, but by ratio it is still way below Europe.

Moving on to page 2, I think the delay of Japanese companies' initiatives is particularly noticeable when it comes to gender diversity. The graph on the upper left shows the share of female directors. Since 2014, when women's active participation was promoted as a core strategy of Abenomics, the share of female directors has remarkably increased in Japan as well but it has increased even more in Europe which means Japan’s relative position has actually worsened.

Even more shocking is the information shown on the lower left. Among the companies previously listed on the First Section of the TSE, over 30% have had no female director for at least 10 years, and I presume they have never had one since their foundation. Obviously in Europe and North America, there is almost no such company. When we have these discussions with companies’ representatives, we often hear that directors shouldn’t be appointed because they are women, but because of their credentials. Yet, I think one has to admit that an absence of female director since founding or for 10 consecutive years is the result of a company’s lack of commitment to women’s active participation. Currently there are still many such companies in Japan.

Page 3 deals with the effectiveness of boards of directors, which are formally well regulated but whose viability is less obvious. We have inserted here the example of a certain company. This company’s board of directors surpasses other Japanese companies in terms of diversity; however, the “Message from outside directors” reveals that these directors have a limited understanding of the achievements in corporate value creation. Many outside directors are probably in the same situation. I think improving effectiveness is incredibly important from now on.

Page 4 deals with the lack of substance in “Comply or Explain.” We have inserted the “Explain” section of a certain company’s Corporate Governance report. There is a great quantity of Explain items, and many of the descriptions have remained identical for several years. The company is listed on the Prime Market, which requires higher governance standards. Our understanding is that not a few companies are more or less in the same situation.

On page 5, the historical chart shows the performance of TOPIX and the S&P Composite 1500 Index over the past 10 years, reflecting the state of corporate value creation. Looking at the past 10 years, or even the past 3 years, one gets the impression that companies’ initiatives are increasingly polarized. The graph on the right side shows the change in the P/B ratio distribution for TOPIX.

Compared to 10 years ago, the share is improving, but more than half still has a P/B ratio below 1.

Moving on to page 6, we identified the insufficiency of regeneration mechanisms as a characteristic of Japanese companies. The table on the upper half shows a comparison of change rate of stock prices between Japan and the United States. For Japanese companies, the older the timing of their integration, the worse their performance, while American companies perform better the older their integration. The same trend is observable even more strikingly when it comes to the P/B ratio.

On to page 7. I've mentioned that the longer Japanese companies had been listed, the worse their performance was. I think one of the reasons for this is their dependency on cross-shareholdings. We indicate that the longer a company has been listed, the more it depends on cross-shareholdings.

Page 8 is about the Standard Market. The left-hand graph focuses on the Japanese situation, with a comparison between the shares of the Prime Market, the Standard Market and the Growth Market within the market overall and within Fidelity's portfolio. On a stock name-basis, the Prime Market accounts for half of the market in general with non-Prime Market companies making up the other half. Fidelity's portfolio is composed mostly of Prime Market companies. Therefore, we now have this issue of how to make the Standard Market appealing to global investors. In reality, as is shown on the right-hand graph, even in the more mature American markets, investment activity is poor in markets that do not possess clear characteristics. Like TSE, NASDAQ is divided in 3 market tiers and investment flows in large majority towards the highest-ranked Global Select tiers, with the two other inferior tiers not attracting much funding. That means, in America as well, investment does not increase in markets which lack clear characteristics.

Page 9 is about the Growth Market. Currently in Japan, the liquidity of emerging markets is extremely low compared to the main market. By contrast, the United States has NASDAQ, with a dynamic trading activity comparable to the main market. In my opinion one of the reasons is the lack of integration of emerging companies into TOPIX. The graph on the left indicates the share of

NASDAQ companies in the S&P Index, and I think TOPIX must include emerging companies as well.

Moving on to page 11, with a comparison between TOPIX and the S&P 1500 regarding their number of component stocks and the evolution of their replacement rates. While the number of component stocks remains stable for the S&P 1500, it grows progressively for TOPIX. Moreover, many stocks are removed from the S&P 1500, so stock replacement is brisk.

On page 12, we show that such differences in index rules influence performance. When comparing the performance of stocks that constitute the S&P 1500 and those that do not, we see that there's a big performance gap between companies that have been continuously included since 1996 and those that haven't been included once. In view of this, we can also say that the competition between companies for limited space leads to performance. On the left-hand graph, we have color-coded constituent and non-constituent stocks of the S&P 1500 and ranked them by market capitalization. It appears that stocks are not added to the S&P Index 1500 by order of market capitalization.

Page 14 is the summary.

First, concerning the Prime Market, one can argue that global investors scrutinize how companies appoint female directors. In light of these global standards, we think it is important to consider taking a strong stance, such as boldly rendering such appointments mandatory.

In addition, regarding independent directors, the goal is to move from formality to substance. It would be preferable if there were more opportunities for investors to express directly what they expect from independent directors, as representatives of shareholders in general.

Disclosures are a good way to start. We could think about asking for a disclosure of the number of meetings between independent directors and investors, in the Corporate Governance Report for example.

I think the lack of substance in "Explain" impacts the credibility of the Prime Market. It's important to demand a clear justification in the "Explain" section, such as “presently strict observance is not appropriate in the context of corporate value improvement,” instead of allowing a simple “under consideration.”

Regarding companies with a P/B ratio below 1, there are varying opinions on whether this should be a criterion for inclusion in the Prime Market or in TOPIX. If having a P/B ratio below 1 becomes an absolute criterion, I think it’d be more advisable to adopt it as a condition to join the market rather than for TOPIX. And before that stage, I think it’s important to ask for measures such as an improvement plan for corporate value, as it relates to the investment and best use of intellectual property and intellectual property, as is already specified in the Corporate Governance Code.

I think it’s also important to create qualitative standards for the transition toward the Prime Market, in addition to the quantitative criteria I’ve mentioned until now. The right number of companies for the Prime Market will probably be determined naturally as a consequence.

Regarding the Standard Market, as I’ve said before, the situation is the same as in the United States, with an unclear positioning. It would be good to first stimulate the Prime Market, and then aim for the Standard Market to reach the Prime Market in order to stimulate the overall market.

Regarding the Growth Market, we think it would be beneficial to stimulate the market through liquidity improvement with inclusions in TOPIX, and through increased opportunities for constructive discussions with global investors.

When it comes to the revision of TOPIX, I think the most important issue is to set an upper limit for the number of included stocks. This should further regenerate the markets naturally. We should try to increase the appeal of the markets through TOPIX as well, in addition to the tightening of the Prime Market standards.

Finally, and this isn’t written in the documentation, we often hear the expression “market representativeness” in debates about TOPIX. I think the definition of “market representativeness” must be clarified. “Market representativeness" does not mean including a lot of individual stocks, but building a superior index will ensure that it ultimately represents the market. We believe TOPIX should be considered with this approach.

That is all from me.

[Kikuchi, Director, Listing Department, TSE]

Thank you very much. I will now ask for questions and opinions from members regarding the explanations we've just received.

[Sampei, member]

Thank you for your explanation. I think the last point you added is extremely important. And in the document 2 that you've just explained, page 11 drew my attention. The reason is that when I looked at the replacement of businesses in individual Japanese and American companies, I noticed the exact same shape as this graph comparing Japanese and American indices. In short, a graph indicating the increase in businesses and the discontinuation and replacement of old businesses was shaped exactly like this one. Japanese companies can only add up, and cannot subtract. This is the Japan disease, so to speak.

Related to this, with respect to the Stewardship Code, in the United Kingdom, around the time when the number of adopting institutions surpassed 300, concerns about quality emerged. Each institution went through interviews starting in 2016 and was classified into several categories, depending on whether its response was satisfactory, in need of improvements, or not satisfactory. And from around just last year, authorities began to take a look at each company in detail and sometimes stopped acknowledging an institution's acceptance of the Stewardship Code, despite that institution having previously announced its adoption of the Code. As a result, even though 308 institutions had stated their acceptance of the Stewardship Code in 2021, today that number has fallen to 199, since some were not acknowledged. In that way, to seriously emphasize quality, we need a strict system that deems certain insufficiencies unacceptable. Therefore, constituent replacements should be enforced in TOPIX, and for market segments as well, a below-standard performances should be met with a strict response, regardless of the creation of a fixed grace period, otherwise quality will deteriorate. That's all from me.

[Matsumoto, member]

I pretty much agree with Mr. Ikawa's entire explanation. Since observers from the Ministry of Economy, Trade and Industry (METI) and the Financial Services Agency are present today, I would like to refer to the second point of the last page of Document 2, regarding discussions between independent directors and investors in the Corporate Governance Report. Normally, when shareholders want to speak with independent directors, discussions should take place in the normal course of events because independent directors are the shareholders' representatives. I believe this is also specified in documents from METI. However, in reality, when we try to access independent directors, we sometimes hear: "I'll ask the company's president." Or, in the case of an independent committee, like when a subsidiary is bought back by the parent company, the independent committee shall not represent shareholders in general but minority interests. This is also clearly written down in the METI documentation, but some companies openly disregard the recommendation. Or rather, I think they don't understand it. This is similar to the "under consideration" in the "Explain" section.

From these three examples I have just given, one could say that, in the present situation, listed companies that proceed without understanding the systems and frameworks are left as they are. What I mean is that even though all sorts of systems are created there is no implementation. I don't know who from the government or TSE should be in charge, but I think we need to not only create systems, but also follow up properly and correct mistaken companies. Without this, I don't think enforcement is possible, no matter how many times the systems are modified. Thank you.

[Kuronuma, member]

The sustainability element and corporate value with a focus on the P/B ratio came up in today's explanation. I think some might take the stance that corporate value increases if the issues of sustainability and ESG improvement are addressed. But when adopting that position, we must assume there is a correlative relationship between the two. Otherwise, I feel the discussion could become somewhat perilous. If we suppose that boosting corporate value is the ultimate goal of the market restructuration, I think it's good to use the P/B ratio as an indicator. However, when it comes to choosing which element matters for its improvement, we must debate based on such correlation. I personally agree with the opinion that we should insist on the ESG element and that the inadequate initiatives by Japanese companies and more specifically companies listed on the Prime Market must be improved. Still, I think we should be careful regarding that point during our discussions.

[Nagami, member]

Thank you for your explanation. The last topic brought up was “market representativeness,” and I also believe that is a key word. Related to this, on the right-hand graph presented page 5 of Document 2, we see that currently half of the companies constituting TOPIX have a P/B ratio inferior to 1. I think it’s important to wonder whether this is a good representation of the market. As I said the previous time, I think a long-term P/B ratio below 1 signals that management either doesn’t sufficiently take advantage of the market, or doesn’t regard stock value as important. Asking whether the continuous inclusion of these companies can be considered a good representation of the market might lead to a debate on TOPIX itself and to the debate on market restructuration. For this reason, it’s important to face this issue. That’s all from me.

[Ando, member]

Even listening to the members’ opinions, it’s an undeniable fact that Japanese corporations themselves have many issues they must overcome. One of the underlying reasons is that autonomy is not working, and that is a fundamental problem. Measures and points of attention to generate sustainable corporate value creation are specified in various codes, guidelines and guidance papers, but these are only building blocks. As I commented during the first council, I think managers must once again sort out what the “essence of sustainability management” is, fully understand the meaning, and then implement. In that sense, even in the case of strong enforcement by stakeholders, if corporate management doesn’t act with autonomy, productive results will not be obtained. Since this follow-up council is attracting a lot of attention, I would like to be granted an opportunity to explain the concepts that I believe corporate managers are missing, as well as the necessity of a paradigm shift. I kindly ask the secretariat to consider this proposition. Obviously when considering the present situation with large number of companies P/B ratio below 1, one has to admit that the situation of each market is quite critical, and my perception is that things can't be left as they are.

[Kikuchi, Director, Listing Department, TSE]

We will consider your proposition internally.

[Fidelity International, Kubo, Officer, Head of Legal and Compliance]

I would like to add a brief comment. Professor Kuronuma brought up the issue of determining what sorts of viewpoints are plausible. Right now, we are also struggling with that question internally. I can't share specifics here but, in line with member Nagami's remarks, we also believe we need to consider market restructuration and TOPIX as indivisible, like two wheels of a cart, in order to pursue the discussions. I think the two are not basically indivisible, but are independent and healthily connected. However, as it turns out, the positioning of TOPIX as an index has become an incredibly important factor and, on a practical level, we still need to discuss how we should consider it in terms of its relationship with market restructuring. I think our discussions will be quite limited if we only look at market restructuring.

[Kanda, member]

Thank you for your explanation. I have a question. On the last page of Document 2, you mention "the correct number of listed companies on the Prime Market." What do you mean by that concretely? If you think there should be fewer companies, what do you think of the relationship between the Prime Market and the index? Let's assume there are fewer companies on the Prime Market. Should they all be constituents of the index, or should they be seen as separate from the index, since listed companies cannot be frequently included and removed from the market like they can be from an index? Can you please share your thoughts on that topic?

[Fidelity International, Ikawa, Head of Engagement and Portfolio Manager]

Thank you for your question. First, regarding the number of individual stocks, global investors were disappointed by the fact that the number of listed companies on the Prime Market would be about 1,800 at its start and did not vary that much compared to 2,100 companies on the original First Section. Moreover, transitional measures were applied to several hundreds of these companies, as part of the listing criteria. In view of this, I think it's clear that the current number of listed companies is too high. In this context, there's no answer to how many companies there should be, but during the preparation of the rules for the Prime Market, I think restricting the number of qualified companies would have led to a determination of the number of Prime companies. It is odd that we end up with roughly the same number of companies on the First Section, which didn't have many rules, and on the Prime Market, which has many. And finally, TOPIX should be discussed as a separate matter. Even if a company is listed on the Growth Market, if that company represents the market, it should be included in TOPIX.

[Okina, member]

Thank you for your explanation. I have two questions. I agree with your interpretation of what a P/B ratio below 1 means, but when it comes to the ways to improve it, we can think of various means, such as pressure from the investors' side, or the standards to integrate an index like TOPIX. Which of these approaches do you think is effective, if any?

Now for my second question, we always hear that what is important about governance is not formality but substance. If we assume that, on a long-term basis, capital profitability naturally surpasses capital cost, and that the issue of sustainability is also seriously handled, how does your company evaluate the quality of a corporation's governance? I guess you understand a lot through disclosures and engagement, but what elements do you particularly pay attention to in your evaluation? Several topics have come up in today's discussions but, as an investor, what do you especially look at in the disclosures and in your engagement operations?

[Fidelity International, Ikawa, Head of Engagement and Portfolio Manager]

Thank you for your question. Regarding your question on the P/B ratio, Mr. Ando also offered an explanation. Autonomy is what matters most, and we can't constantly tell corporations what to do. So, I think corporations taking the actions they consider appropriate eventually influences mid- to long-term value creation. In that sense, rather than imposing rules around the P/B ratio, we think that if the number of companies in TOPIX is restricted to stir competition, corporations will probably react on their own. Therefore, efficient use of that framework will improve corporations' autonomy, and the P/B ratio will also naturally rise as a result.

For your other question about governance, I think the answer is the same. The goal of our engagement is simply to have corporations change their thinking patterns of their own accord. Even if we coerce them into acting a certain way, it would only happen once and end there. In order to obtain long-term returns, corporations have to change on their own, that's the reason for engaging. In view of this, what we value the most is this kind of change in mindset. Whether this can be sensed through the disclosures depends on the corporation, but at any rate, it's important for us to feel that the company is changing.

[Matsumoto, member]

Regarding what was just said on the P/B ratio, in terms of market restructuring and the index, I think it makes sense to argue that corporations with a high P/B ratio should be included in the Prime Market. But if the goal is to use capital markets to strengthen Japanese society and improve productivity, removing companies with a low P/B ratio from the index or the Prime Market and leaving them be will not change society's productivity. If these companies do not withdraw, productivity will not increase. One thought comes to my mind in relation to this. Normally, if a company's P/B ratio is extremely low, investors should be able to apply arbitrage to bring the P/B ratio back to 1, such as buying it, cutting it up, and attaching it to another company; however this is not accepted in reality. For example, it's pretty difficult to buy several regional banks, merge them, break them up. And if, as is being discussed here, companies were to be removed from the Prime Market, some would ask for the creation of a new market tiers to receive them. It seems as if our country will decide against a thorough withdrawal from all markets. This might not be TSE's problem, but I think these companies should be properly withdrawn, and these removed elements should find an application in some other form; otherwise, it's meaningless. I'm not sure this fits today's themes, but if we don't integrate these matters in our talks, all in all, I believe there will be no point in modifying the index.

[Kikuchi, Director, Listing Department, TSE]

Thank you very much.

Next, we will hear from JPX Market Innovation & Research.

Today we are joined by Executive Officer Takahashi and Head of the Index Business Miura.

[JPX Market Innovation & Research, Takahashi, Executive Officer]

Thank you for giving me the opportunity to explain TOPIX's restructuring today.

I am Takahashi, in charge of the Index Business at JPX Market Innovation and Research. Thank you for having me.

JPX Market Innovation & Research, Inc. started operating in April of this year. We provide index and data services as well as services in new fintech-related businesses.

The index business was transferred from TSE in order to improve the independence and transparency of index management.

I will now proceed with my explanation following the document. Please look at page 2.

First, I will present the issues pointed out in the Final Report by the Expert Study Group on Capital Markets published in December 2019, and how our company responded.

On the left are the findings identified in the report, on the right is our response.

The first finding is, "it is suitable to separate the scope of market segments and that of TOPIX." On April 4, 2022, when the transition toward the new market segmentation took place, a few companies out of the First Section, meaning out of TOPIX, chose to join the Standard Market. Consequently, TOPIX is now made up of stocks from the Prime Market and stocks from the Standard Market: out of the 2,169 constituents of TOPIX, 1,836 are from the Prime Market, and 333 are from the Standard market as of the end of August.

As a result of the segment choices made by listed companies, there is no more connection between TOPIX's constituents and specific market segments.

With the upcoming transition, companies with a market capitalization of tradable stocks below 10 billion yen will be removed even if they are listed on the Prime Market, so we are making further progress regarding the decoupling with market segments.

Next, I will introduce four findings of the Report concerning the direction of the TOPIX revision.

Firstly, the goal should be for the index to be convenient for institutional investors and satisfactory to corporations. Secondly, it is appropriate to strongly emphasize liquidity, while still ensuring continuity since TOPIX is widely used by pension funds and investment trusts. Thirdly, a more specific review item: the adoption of the market capitalization of tradable stocks as a criterion, following a review of the definition of free float. And finally, the criteria should be set with the market capitalization of tradable shares on the Prime Market as a reference.

Please notice the asterisk outside of the table regarding the second finding which states that "TOPIX is widely used." As of the end of March 2022, assets linked to TOPIX such as those managed by ETFs, investment trusts and pension funds amounted to 80 trillion yen.

On the right hand is our company's response to these findings. We held an index consultation in December 2020 and decided on the following measures in April 2021.

The first two arrows are about the direction and general meaning of the revision as a whole. The two items are, "to transit in stages so as to minimize the impact on the market while ensuring the continuity of TOPIX, which is widely used," and "to delink TOPIX from market segments, and aim to further improve its functionality as an investment target, in addition to its market representativeness."

The two following arrows indicate more specific responses to the revision. Regarding the calculation method for the free float weight (FFW), cross-holdings are considered fixed shares and progressively removed from the free float; and the proportion of constituents with a market capitalization of tradable shares below 10 billion yen in TOPIX is progressively reduced, until final removal from TOPIX.

The revision of the free float has been completed in three stages from April to June of this year.

Concerning the removal of constituents with a market capitalization of tradable shares below 10 billion yen, starting from October of this year, their proportion will be gradually reduced every quarter in 10 steps. Completion of the removal from TOPIX is planned for the end of January 2025.

Please look at page 3.

Concerning TOPIX post-removal of the constituents whose weight had been progressively reduced, the Report indicates that “there were some comments on capping the number of constituents and changing the composition of TOPIX on a regular basis, or taking into account qualitative factors such as governance. These issues may need to be discussed further.”

In response to these points, we are pursuing our discussions on the rules for selecting constituents of TOPIX from February 2025 onward, when the progressive weight reduction is completed. After drafting a first proposal, we will collect opinions via an index consultation, and decide on the rules.

Finally, let me share our response to the finding “to explore measures that ensure the independence of index calculation and the continued fairness of the process, so as to eliminate concerns of conflicts of interest with TSE.” We have implemented an index consultation, which is an opportunity for the public to comment on the index, and an index advisory panel to receive opinions from index users. In addition, there were structural initiatives such as the transfer of the Index Division from TSE to JPX Market Innovation and Research, in order to improve independence and fairness.

Please look at page 4.

This is an explanation of the process of determination and re-evaluation of constituents whose weight is to be progressively reduced. This process is also a product of the index consultation.

The determination and evaluation take place three times roughly every other year, with a “first decision,” a “second decision,” and a “re-evaluation” in order to reflect the initiatives by companies with a market capitalization of tradable shares below 10 billion yen to improve market capitalization.

We are currently in the middle of final preparations for the second step of the determination process which will occur in October 2022. Following this step, the first weight reduction will be enforced for the constituents with a market capitalization of tradable shares below 10 billion yen.

In the lower part of the figure, re-evaluation in next October is mentioned. If the constituent’s market capitalization of tradable shares is lower than 10 billion yen, its weight is reduced, and the constituent is definitely removed from TOPIX at the end of January 2025.

If the re-evaluation reveals that the market capitalization of tradable shares surpasses 10 billion yen, and if the trading turnover ratio is 0.2 or higher, the lowered weight is gradually restored.
If the market capitalization of tradable shares surpasses 10 billion yen, but the trading turnover ratio is below 0.2, the weight reduction is interrupted.

Please look at page 5.

This is the status of our company’s index governance.

In July 2013, in the aftermath of the 2012 LIBOR manipulation scandal, International Organization of Securities Commissions (IOSCO) formulated and published the “Principles for Financial Benchmarks,” intending to “promote the reliability of Benchmark determinations, and address Benchmark governance, quality and accountability mechanisms."

These principles have a wide scope of targets: interest-rate indices as well as stock indices. In those 19 principles are defined concepts such as "governance," "quality of the benchmark," "quality of the methodology," and "accountability."

Consequently, in July 2014, we evaluated our own status of compliance with the principles, and started sharing our findings. In March 2017, we prepared and published various regulations, such as the "Policies Concerning Calculation of TSE Indices" which notably establish the governance structure for indices administration and procedures for the revision of calculation methodologies. Since July 2017, we have enforced external audits by PwC and have published the results.

Moreover, and this has already been mentioned, in response to the December 2019 Final Report by the Expert Study Group on Capital Markets, we learned from the initiatives by global indices companies such as S&P, FTSE, and MSCI to introduce the Index Consultation and the Index Advisory Panel in April 2020.

As written in the annotations, according to the IOSCO Principles, the method for consulting and notifying users in the event of a modification of the calculation methodology should be clearly defined. In line with this rule as well, we set up the Index Consultation to gather various opinions on index revision, and the Index Advisory Panel to regularly exchange opinions with index subscribers so as to continuously improve indices, as you can see on the bottom table.

Please note that the current Index Advisory Panel is comprised of members from 14 institutions such as asset management companies and asset owners.

Please look at page 6.

This is a presentation of the opinions of the Index Advisory Panel, which I've just described.

The Advisory Panel convened for the first time in June of last year, and for the second time in July of this year, and expressed the opinions set forth below regarding the future of TOPIX. Please note that these opinions are also posted on our website.

I will briefly name the opinions shared in the first meeting, starting from the top: “significant changes should be avoided if they will not suit the convenience of asset owners,” “it is important to consider market representativeness, comprehensiveness, transparency and convenience,” “stocks whose liquidity drops should be removed from the constituents, even if they are listed on the Prime Market ,” “there is a concern that as the liquidity criteria for the new TOPIX are the same as the listing criteria for the Prime Market, TOPIX will end up with the same constituents as the Prime Market,” and “in the United States, the CRSP US Total Market Index represents all the listed companies in the country and has linked assets under management of more than JPY 23 trillion, so there is also demand for investing in an entire market like this.”

Please look at page 7.

The second Advisory Panel was convened in July of this year and the following opinion, at the top, was shared by all members: “it is important to raise the liquidity criteria for TOPIX and increase functionality as an investable index while maintaining its level of representation of the market and ensuring continuity as an index with many users.”

Regarding the liquidity standard for the selection of constituent stocks, we received the following opinions: “the market capitalization of tradable shares at 10 billion yen, a standard for the TOPIX transition, deserves more consideration,” “a gradual increase is needed,” “after taking into account continuity, there should be a revision from the perspective of global asset managers,” “it is necessary to verify whether the market capitalization of tradable shares is a valid indicator for liquidity.”

Furthermore, regarding the constituents, the following opinions were shared: “considering market representativeness, the number of individual shares included should be fixed at a certain level,” “if they meet the liquidity criterion, why not include stocks from the Standard Market or the Growth Market?” and also “standards must be created for the selection of stocks if they have sufficient scale and liquidity, regardless of where they are listed, while keeping continuity in mind.”

Please look at page 8.

This is the continuation of the previous page. Regarding ESG, we mostly heard the following opinions: “attitudes towards ESG are in flux and at a development stage,” “considering the current situation where there is no guarantee and supervision with respect to the disclosure of ESG information, it is premature to introduce ESG factors into the selection criteria for TOPIX constituents,” “if TOPIX does include ESG factors, they should be kept at a minimum,” “it would be preferable to cover ESG with a different index.”

This was an overview of the Index Advisory Panel’s opinions. We will use this kind of users’ point of views as a reference in our analyses on the future of TOPIX.

Please look at page 9.

To conclude, here is a presentation of the latest initiatives regarding indices.

With regard to indices related to ESG, as you can see in the following table, we have started calculations for a comprehensive ESG index and a net-zero index focused on the environment in March and April of this year, in collaboration with S&P and FTSE.

Pages 10 and 11 are reference materials.

On page 10 is the line-up of our indices. TOPIX and market tiers-specific indices are at the top. The Tokyo Stock Exchange Prime Market Index, the

Standard Market Index and the Growth Market Index were created in response to the new market segments, and we calculate them for statistical purposes.

In the second row are indices associated with the scale of the market capitalization, and the third row comprises industry-specific indices.

Below are “Co-brand indices,” which were not calculated by us only but in collaboration with other index vendors such as Nikkei, S&P or FTSE.

The bottom row, “Others,” contains other indices classified by factors like value, growth, or the payment of high dividends.

Please take a look at “Tokyo Stock Exchange Mothers Index” at the very bottom right. Presently we keep calculating it using stocks from the Growth Market as constituents. In October of next year, we plan to change the index name to reflect the new market segments. The tentative new name is “TSE Growth Market 250 Index.”

On page 11 is a comparison of the performances of the main indices in Japan, the United States and the United Kingdom. The green dashed line at the top represents S&P 500, and the green solid line represents the CRSP US Total Market, which targets all the companies listed in America. Looking at the period after January 2014, they performed in much the same way.

This concludes my long explanation.

[Kikuchi, Director, Listing Department, TSE]
Please share your questions and opinions in relation to the explanation we have just heard.

[Kuronuma, member]
I don’t know if it’s appropriate to ask this question to JPX Market Innovation & Research, but you are now working on progressive weight reductions. In preparing for the second step in October 2022, do you know if there are any examples of stocks that were previously the target of weight reduction but

escaped that fate due to this system?

[JPX Market Innovation & Research, Takahashi, Executive Officer]

We are now in the middle of conducting these operations, but some listed companies have spontaneously disclosed that the market capitalization of their tradable shares has surpassed 10 billion yen and that that therefore they are no longer subject to the weight reduction. We will publish the list of stocks affected by the progressive weight reduction in October so it's difficult to speak today on that topic, but I can say that some companies have made progress.

[Matsumoto, member]

Let me ask you one basic question. Is the S&P 500 weighted based on tradable shares?

[JPX Market Innovation & Research, Takahashi, Executive Officer]

The S&P 500 and the CRSP US mentioned on the last page of Document 3 are float-weighted indices, and so are TOPIX and the JPX-Nikkei 400.

[Sampei, member]

I won't ask a question but would like to share my thoughts. When reading the opinions of the Index Advisory Panel, for example those expressed in the first Panel, I'm left with the impression that the goal is unclear. The points are inconsistent. An index is first and foremost a financial product so, given that premise, one can say that returns are an extremely important factor, since they express the quality of this financial product. But it seems there was discussion with this perspective in mind. Regarding the opinions expressed during the second panel (on page 7), they are all about liquidity, except the third comment starting from the bottom. Attendees might have been encouraged to comment on liquidity that day, but it looks like the discussion were mostly about tactics instead of strategy. In relation to liquidity, what is common sense in Japan is considered senseless in the rest of the world. In Japan many say that "supply and demand determine the stock price," but in my experience in the U.S. and Europe, the view that "intrinsic value determines the stock price" is more common. Only traders talk about supply and demand. Supply and demand determining the price is true for commodities, so this means stocks are mistaken for commodities. That belief might be the reason why corporate value doesn't improve. In reality, corporations produce cash and therefore have an intrinsic value. If we consider this fact and postulate that "increase of intrinsic value = returns," then we have to attach more importance to this increase. The expectation of this increase is the reason why even if one person sells another person else will buy, because an even higher increase is expected. The result is an improvement of liquidity. As such, liquidity will not improve if there's no readiness to increase intrinsic value. If we start by talking about liquidity, which is the outcome, we're only chasing after that outcome. I'm not sure this is the right way to proceed.

Moreover, I don't see the emphasis on strategy on page 8 either. The third comment from the top about ESG implies that corporate value and ESG are completely unrelated. This is very strange in my opinion, because the aforementioned intrinsic value and returns are not taken into account. In this context, I wonder if it makes sense to review indices using the opinions of the Advisor Panel as a reference.

[JPX Market Innovation & Research, Takahashi, Executive Officer]

The Index Advisory Panel is comprised of asset managers and asset owners who use our indices. Discussions of the specific selection criteria for constituents are avoided so as not to invite concerns that unfair trading such as front-running might occur.

Moreover, regarding liquidity, many of our panel members basically invest in TOPIX passively, and the 2019 report from the Financial System Council contained recommendations on liquidity. This is probably why there were many comments from attendees about the need to improve liquidity. This is a complicated topic for us as well, but if the index is not used by investors, it's impossible to employ investment in that index as a motivation tool for listed companies and improve the markets overall. For this reason, we pay close attention to the opinions of actors who actually use the index, and will refer to them in our upcoming discussions.

Nevertheless, when we determine practical rules such as the calculation methodology, we go through the Index Consultation first and then proceed with our response using the findings.

[Kanda, member]

I have a question about the last page of Document 3. In Japan, TOPIX and the JPX-Nikkei 400 move much in the same way. If we assume this is always the case, for buyers, purchasing one or the other achieves the same result, so it becomes pointless to work painstakingly on upgrading TOPIX. Why do you think that is? Intuitively I would say that the companies in the JPX-Nikkei 400 influence TOPIX.

[JPX Market Innovation & Research, Takahashi, Executive Officer]
The JPX-Nikkei 400 as well as the S&P 500 in the U.S. and the FTSE 100 in the U.K. represent around 80% of the total market capitalization of their respective markets. That is probably why indices representing a smaller portion of these markets and those representing the whole markets move in roughly the same way.

Although the S&P 500 is well established in the U.S., some investors, especially universal owners, wish to diversify their portfolio. Our understanding is that TOPIX is leveraged from that perspective. Because we have been discussing the revision of TOPIX for the past two or three years, we want to keep improving its sophistication and molding it into an index easy to use for investors and motivating for listed companies.

Furthermore, a single index can hardly meet all needs, which is why we are considering new index variations. And for these indices to be used in the future, we also want to promote them.

[Ando, member]
Thanks to today’s explanation, I now understand the process of the Index Consultation and the relationship between the Index Consultation and the Index Advisory Panel better. At the same time, the panel is only made up of users, but opinions sometimes differ even among users. Will the opinions be consolidated? Moreover, if the panel reaches two competing conclusions, am I correct in saying that the ultimate decision is made by the Index Consultation? I am asking for a confirmation because, even after reading the published discussions’ summaries, I didn’t get the impression that every company was debating.

Furthermore, the names of the 14 member institutions have been disclosed, but not the names and titles of the people actually participating. Is there a reason for this? Because I think it's relatively important to know whether the panel members are CEOs, CIOs, or department heads. Besides, I would also like to know if every member company shares the same perspective as the panel members.

[JPX Market Innovation & Research, Takahashi, Executive Officer]
The "Index Advisory Panel Administrative Guidelines" state that panel members are legal entities, so the attendees are representatives from each member company. Many of them are CIOs in charge of asset management or department heads, which means they make practical decisions on asset management.

[Matsumoto, member]
This was mentioned previously by Mr. Kanda, but when looking at page 11 of Document 3 and page 11 of Document 2, it seems that it doesn't make much sense to review market segments, and on the other hand it makes sense to strictly monitor entries and removals. It appears that the reason why TOPIX behaves similarly to the JPX-Nikkei 400 is that there is very little replacement of the constituents, as shown on page 11 of Document 2. Therefore, I really can't help to think that the discussions surrounding market segments have to decisively put an emphasis on removals, or there won't be any deterrent effect.

[Kanda, member]
I agree with pretty much everything Mr. Matsumoto said. I think market segments are not a sufficient condition for the rise in corporate value and the growth of Japanese companies, but they are only one instrument. Same thing can be said about the Corporate Governance Code. This alone will not resolve the issues. Since Mr. Matsumoto also made more qualitative points, and Mr. Ando also talked about a more intrinsic topic which is autonomy, I would like to add a brief comment. I believe the biggest problem is that companies feel no sense of danger. Even with a P/B ratio below 1, some companies bring up their record-high profits. With a few exceptions, listed companies do not understand the basic idea that they are evaluated on the stock market. As such, I've made several proposals at different occasions but, as Mr. Matsumoto said, if we look

at the numbers, Japan pales in comparison with the rest of the world. This is quite a difficult topic but since this is a follow-up council on market restructuring, I believe moving forward even just one step is a good thing.

[Kikuchi, Director, Listing Department, TSE]

Thank you very much.

This concludes the participation of our guests. My apologies but I now have to ask the guests to leave the room.

We will use the remaining time to explain the developments that transpired during the preceding discussion and the resulting procedures for the next council, based on the document at hand. Please share your opinions afterwards.

[Ikeda, Manager, TSE]

I will now explain Document 4 that you have at hand. I will keep this explanation brief as we've already given it before and because we would like to dedicate a considerable time to discussions.

During the last Council, we received a wide range of opinions regarding documents' contents and we have summarized them. So today I would like to hear your additional comments.

On page 1 are presented the general topics. The comments we gathered regarding the objectives of the future discussions and the future procedures are shown here.

Our goal is to proceed with a sense of urgency and deepen the debates, using means like interviews and public consultations to determine what issues should be addressed in priority. If you have any suggestions regarding the procedures, please share them with us.

From page 2 onward detailed topics are introduced, starting with the Prime Market and the Standard Market.

Regarding the Prime Market, we received opinion on companies with a P/B ratio below 1, as well as comments on the necessity of English disclosures, and the importance of investors actively participating in the dialogue. Regarding the Standard Market, the necessity to revitalize the market by communicating the changes within listed companies, for example, was mentioned.

On this topic, we would like to deepen our discussions of the issues mentioned and explore any additional issue while conducting hearings of institutional investors and holding public consultations. If you have any additional comments at this stage, please share them.

Page 3 is about the Growth Market. The issues mentioned included the need to find ways to help companies achieve significant growth and to strive for regeneration, the necessity to encourage information disclosures, and the importance of the participation of institutional investors during IPOs.

Furthermore, from a scale perspective, it is currently relatively easy to go public on the Growth Market which therefore plays an extensive role. With regard to this fact, it was also argued that a secondary market for unlisted stocks could make the ecosystem more seamless overall.

We plan to deepen discussions by conducting hearings of venture capital firms and other stakeholders related to startup companies. Again, if you have any additional comments at this stage, please share them.

Finally on page 4, we have the transitional measures.

As pointed out, in order to properly represent the concept of market restructuring, which has been an objective all along, and also to make things more foreseeable for listed companies, it is important to promptly determine and clarify our policies.

We have received several opinions regarding how to accomplish this in practice and we would like to promptly deepen discussions while conducting hearings to ascertain the actual status of companies.

Below are additional remarks we have included this time about the securement of selling opportunities for shareholders after transitional measures are terminated.

Regarding this point, the previously-formed Financial System Council's Expert Study Group on Capital Markets had indicated that selling opportunities should be secured for shareholders if strict removal standards were adopted. In line with this orientation, and because this is mainly a technical topic, TSE plans to conduct a practical study on the matter.

The next page shows the status of companies that do not meet the continued listing criteria, as shared at the last council meeting. Keeping in mind the possibility of companies being delisted due to a lack of improvement and the need to minimize the practical impact on market participants, one idea could be to leverage and extend the current designation period for Securities to Be Delisted. As we are proceeding with our studies, we appreciate any suggestions you might have.

This concludes the explanation.

[Kikuchi, Director, Listing Department, TSE]
If anyone has a question or an opinion concerning the explanation that was just given, please go ahead.

[Kanda, member]
I have two remarks.

The first one is about the future procedures. I think the listed items on page 1 of Document 4 are sufficient.

My second point concerns the impact on shareholders in the event of a delisting. I almost agree what is indicated on page 4 of Document 4. That is, TSE will conduct a practical study and report the results in this council so we can discuss them. Concretely, I think there are two possibilities. One is to improve the current system for the designation period for Securities to Be Delisted and extend it. The other one would be to conceive a new system that departs from what the name “securities to be delisted” implicates. The practical perspective is extremely important regarding this topic, so it would probably be good for TSE to investigate this issue.

[Nagami, member]

I will briefly go over last time and this time’s discussions. Market segments and indices are different concepts, but if we ask ourselves how these two wheels of the same cart can be leveraged properly, I think it’s important to conduct a thorough screening. For the market segments, I believe this screening takes the form of an absolute evaluation. Raising the standards for this absolute evaluation and promptly terminating the transitional period, as was previously mentioned, are the main pillars in my opinion. Regarding the indices, I believe the evaluation should be a relative one in order to promote a certain level of competition. There’s the question of what the right number of companies is, such as the S&P 500 vs. the S&P 1500 in the U.S., but it’s important that the indices be managed in such a way that the number of companies remains the same as one wheel of a two-wheeled cart, so that the market is also managed and revitalized. This is why I think the focus on announcing policies and a timeline as quickly as possible is the most important point of view of this council.

[Sampei, member]

Regarding future procedures, hearings are in themselves a good thing, but I wonder what the response will be if many argue in favor of preserving the status quo and against strict measures. These opinions could be used as an excuse to block the rigidification of application standards. I would like to confirm how such opinions would be dealt with.

In addition, with respect to pages 4 and 5, we should start our reflections with understanding the point of the designation of Securities Under Supervision or Securities to Be Delisted. I guess the surprise created by the designation of Securities Under Supervision was taken into account. I argued last time that transitional measures should only be permitted until the deadlines of the original plan. However, when looking again at the distribution of plan length on page 5, most companies are under five years, so a 2027 deadline for example is also within the realm of possibility. If we accept this hypothesis, if the deadline is either the deadline of the initial plan or 2027, the deadline becomes 2027 for companies with an initial deadline posterior to 2027 and, for companies with a shorter initial plan, the deadline doesn't move or becomes 2027 if they revise the initial plan. In that way, the process would be basically completed in five years. I see this as the "carrot" part of the carrot and the stick.

Now moving on to the "stick," it is possible to publish the list of companies that do not meet the continued listing criteria along with their plan's deadline, in order to create a wide awareness that a lack of progress will lead to a delisting. This particular implication could be conveyed before proceeding with the designation of Securities Under Supervision or Securities to Be Delisted.

In addition, I have a general remark that applies to both delisted companies and TOPIX. There is a belief that once publicly listed companies pass one screening, they will be left alone. This belief has to change. Listed companies should embrace a corporate culture where they understand that competition is constant, that they are judged on their relative merits and that they have to work on improving themselves. And I think a stock exchange's role is also to raise awareness on this issue.

[Kikuchi, Director, Listing Department, TSE]

With respect to the first question on hearings, our premise is that it is better to set up a process with opportunities to hear the opinions of a wide range of market stakeholders. Even if we conduct hearings during this council, the number of people we can contact is limited. We also do not wish to deny anyone the opportunity to express their opinion, so we are planning to hold a public consultation. When it comes to the way we will use the gathered opinions, we will purely refer to them in our further discussions with you.

[Sampei, member]

Thank you very much.

[Matsumoto, member]

I agree with Mr. Sampei's entire remarks. Relatedly, I think collecting opinions through hearings is a good thing in itself. But regarding future procedures, such as the next council, hearings take time. And I assume TSE will then present a summary of these collected opinions to us and we will be expected to reach a conclusion on that day or during the next meeting. In that case, I'm afraid the time dedicated to final discussions and revisions might be too short. If there is not enough time for discussions, there's a risk they might continue as is, without any change. I would like you to consider this point.

Furthermore, I thought Mr. Sampei's comments about the carrot and the stick were interesting, but personally I think it would be beneficial to only use the stick from the start. Five years are considered suitable as a deadline, but my impression is that five years are an extremely long time for capital markets. Five years ago, the coronavirus pandemic hadn't started yet. I think it's better to develop a clearer carrot-and-stick scenario or make the deadlines shorter. Five years are too long.

[Kuronuma, member]

The philosophy behind our discussions was that market restructuring started with the objectives of creating distinctive markets and offering incentives to listed companies to improve their corporate value, and that therefore indices were to be thought of as a different issue separate from market segments. Then, it was argued that market segments and indices were two wheels of a cart and that replacing the constituents of an index would promote competition. I personally don't believe that regularly replacing constituents of TOPIX will generate real competition, raise corporate value and improve the Japanese economy.

As Professor Kanda said, at best, market restructuring will create a sense of danger or become a source of motivation among listed companies. It would be great if stricter criteria resulted in an improvement of corporate value but then again, I have my doubts. In short, we need to establish why competition is desirable and if it will really bring about higher corporate values in order to pursue our discussions. We don't need to settle on this today, so I would like to hear more opinions later on.

[Okina, member]

In response to the remark that was just made about whether market restructuring is a source of motivation, in my opinion it is for some companies but not always so for most companies. For example, to a certain extent, there are companies which, once they are listed on the Standard Market, prepare their transition to the Prime Market or strive to meet the criteria during the transitional period, but my perception is that it's not enough. When it comes to this kind of issue, improvement on disclosure is needed, as Mr. Sampei proposed. For example, with respect to companies' plans to meet the continued listing criteria, a list of timelines and objectives should be visible to the market.

Market restructuring itself may not impact corporate values significantly, but initiatives to motivate companies must be implemented. In particular, I think it's extremely important to communicate messages about transitional measures in a timely manner. Policies must be determined and communicated early, and it's important to hasten the deliberations surrounding that topic.

[Nagami, member]

I'd like to make a sidebar comment. When we consider how to guarantee the self-discipline of the market, I think structural changes are necessary to see some improvement, judging from the facts presented last time. When assessing the present situation, we have to realize that we don't always see good performances and that admitting it can help change things. This is why the idea of competition matters in index discussions.

Moreover, in order to streamline the council's agenda, I think disclosure in English and share of global investors mentioned in the documents are all important. However, from the perspective of corporate value improvement, they are merely the "means." The agenda should be focused on items like the market segments and indices, or the determination of strict and high standards for market segments to reach the final decisions.

[Kikuchi, Director, Listing Department, TSE]

Thank you very much.

The time has come to end the discussions for today.

To conclude, we will provide details on the next council.

[Ikeda, Manager, TSE]

Thank you very much for this animated discussion.

Next time, we will be joined by market players. We look forward to hearing their opinions and thoughts and continuing our discussions.

That is all.

[Kikuchi, Director, Listing Department, TSE]

With that, I hereby declare today's meeting adjourned.

Thank you very much for your participation today. We look forward to talking to you all again at the next meeting.

END