

The Fifth Council of Experts Concerning the Follow-up of  
Japan's Stewardship Code and Japan's Corporate Governance Code

January 20, 2016

[Ikeo, Chairman] It's already past the scheduled opening time, so I'd like to open the fifth Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code.

Thank you very much for taking the time from your busy schedule.

Today, continuing from the last meeting, I'd like you to discuss points at issue on the board. There are many things we could not sufficiently discuss last time, so I'd like to ask you to have focused discussions today.

Including Mr. Oguchi who submitted an opinion paper today and Mr. Toyama who presented an opinion paper for the previous meeting, many members suggested that we should summarize and publish the Council's current view on the board once, in order to help listed companies make decisions on their policies for appointing new directors. This suggestion takes into consideration that listed companies, which hold their general shareholders meetings in June, need to make decisions on such policies from January to February.

Given such suggestions, in today's discussion, please keep in mind that we might publish the Follow-Up Council's opinion paper in the near future. I'd appreciate, in advance, your cooperation.

First, I'd like to ask a representative of the Financial Services Agency to explain issues to be discussed today.

[Mr. Tahara, Director of the Corporate Accounting and Disclosure Division, FSA] I'll explain Material 1 at your hand. It is organized into two broad parts: the first half from page 1 to page 5 which discusses the ideal state of the board seeking sustainable corporate growth and increased corporate value over the mid- to long-term, and the second part from page 6 which focuses on appropriate exercise of audit functions.

In Part I concerning "corporate boards seeking sustainable corporate growth and increased corporate value over the mid- to long-term", we summarized your views which were expressed in previous meetings. Let me explain. Over the 6 months since the implementation of the Corporate

Governance Code, it was reported that there have been significant changes in the boards of listed companies. In the meantime, as it has been just 6 months since the implementation of the Code, corporate efforts are still underway.

Under such a circumstance, while we requested you to discuss ‘the substance, not merely the form’ in light of the purpose of this Council, we are aware that discussions on corporate governance were initially triggered by an awareness that Japanese listed companies have not been able to cope with the rapidly changing business environment.

Accordingly, in order for listed companies to respond to the changes in the business environment, and achieve sustainable growth and increase corporate value over the mid- to long-term, it would be necessary for the management led by Chief Executive Officer (CEO) to constantly make far-seeing and correct managerial decisions.

The Council also pointed out the importance of CEO’s role in making such decisions, and called for an objective, timely and transparent process for appointing and dismissing CEO. Furthermore, as for the board’s function to oversee CEO and the management, the most needed is to secure independence and objectivity. With such independence and objectivity, the board plays the roles described in Principles 4.1 to 4.3, as listed in the material. We organized the logic in this way.

Now I’m moving on to the specifics: what should be done specifically? As described there, the Council has so far discussed the composition, operation, and evaluation of the board. From page 2, you can find specific views concerning the composition, operation, and evaluation of the board. We expect the companies to make such efforts – I must repeat – in a substantial and not formalistic manner. We assume that the Council’s discussions in view of enhancing the substance could be organized in this way.

Let’s first look at the composition of the board. We understand that the following opinions were raised by the members: from the perspective of how the listed companies respond to the business environment and achieve sustainable growth, in order for the board to fulfill such roles and responsibilities as the appointment/dismissal of CEO, strategic direction-setting, and oversight, it is necessary to secure appropriate qualifications and diversity of board members; and it is important that the board secures its independence and objectivity.

Below that, we’ve listed up 4 key points raised by the Council members concerning the board composition. First, with regard to the board composition, we saw the companies making efforts to

ensure a balance of qualifications and diversity of board members depending on the business/stage of individual companies, and it was noted that it is necessary to make further efforts.

As examples of efforts, we summarized examples shared during the Council meetings. I'd like you to take a look at the footnote. It was pointed out that when we provide such examples, the companies tend to follow such examples in a formalistic manner, so we specified that these are just illustrative examples. This is applicable to all other examples of efforts thereafter.

Second, the number of independent directors has seen steady growth. In more than 10% of the companies listed on TSE First Section, at least one-third of their board members are independent directors. Meanwhile, stakeholders are increasingly shifting their focus from the number of independent directors to the balance of qualifications and diversity of board members. Accordingly, it was pointed out that companies need to make efforts in these areas as well.

Please turn to the next page. Third, in addition to the above-mentioned 2 points, we included examples of efforts for securing independence and objectivity of the board.

Fourth, in making such efforts, the Code stipulates a principle that requires companies to explain their views on the board composition, etc. It would be important that such explanations clearly and specifically communicate information regarding how each company's board is composed to fulfill its expected roles in response to the business environment and business challenges.

Now I'm moving on to section 2 concerning operation of the board. It was pointed out that it is important that the board enhances its discussions on strategic direction-setting, appropriate evaluation of the corporate performance, and decisions on personnel affairs of senior management based on such an evaluation, and so on.

We've listed up 4 key points raised by the members under this section as well. First, in order to enhance discussions on a strategic direction, etc., it is necessary to reduce the number of agenda items and secure sufficient time for deliberation.

Second, it is important for internal directors to fully understand that their roles as board members are different from those as management executives.

Third, it is necessary to establish an environment that enables independent directors to contribute more to board discussions on setting a strategic direction, etc., and examples of corporate efforts were presented, as described.

Finally, as part of roles and responsibilities of independent directors, it is important to

appropriately represent the views of minority shareholders and other stakeholders in the boardroom.

Now I'm moving on to section 3 concerning evaluations of the board effectiveness. In this area, I believe that the members discussed how important it is for the board to analyze/evaluate the effectiveness of the board as a whole and to reflect the results in the next steps, thus properly implementing such PDCA (Plan-Do-Check-Action) cycle.

As described in (1), at the end of coming May, one year will have passed since the implementation of the Code. Accordingly, companies are expected to properly evaluate qualifications/diversity of board members, and effectiveness of board operations, etc.

Upon making such an evaluation, companies have made various efforts depending on their specific circumstances, and such examples were presented. However, the primary importance should be placed on an honest evaluation of the board by each board member. As shown in the case of Kao Corporation, such an honest evaluation of the board by each board member is yet to be made. That's why we included this point here.

Please turn to the next page. We summarized item (2) concerning the evaluation and disclosure of the board effectiveness in this way, based on the opinion that it is necessary to evaluate it from the perspective how the effectiveness should be enhanced in a broader context.

As for section 4 concerning the appointment and dismissal of CEO, as mentioned earlier, many members mentioned that it is the single most important strategic decision for the listed companies.

Consequently, for succession planning for the next CEO, a process to secure objectivity, timeliness, and transparency is required. Furthermore, it was also pointed out that, in cases where problems are found with the CEO after conducting appropriate evaluation of the company performance, it is necessary to set a mechanism that makes it possible to dismiss the CEO.

Although we summarized this section in this way, this topic was not sufficiently discussed during the last meeting, so we hope you would have in-depth discussion today.

Please turn to the next page. Part II "appropriate exercise of audit functions" is the broad issue to be discussed in the second half of today's meeting. Taking recent corporate scandals into account, what is required from the perspective of preventing corporate scandals and the like? In the previous meetings, this was not set as agenda, but in the course of broader discussions, 2 points mentioned here were raised. First, it is necessary to have a system where an act of whistleblowing can be

reported to outside *kansayaku* and outside directors.

Second, the *kansayaku* board should consist solely of independent members. With the objective of preventing recurrence of corporate scandals, such a composition of the *kansayaku* board should be considered. Furthermore, the role of the so-called third party committee is supposed to be played by the *kansayaku* board in the first place.

Including these 2 points, we'd like you to discuss 3 points listed in the dotted box today.

The first point is about the appointment of *kansayaku*/Audit Committee members. There was a case where a former CFO chairs Audit Committee. From the perspective that the *kansayaku* board or the equivalent fulfills its roles and responsibilities from an independent and objective standpoint, what do you think the appointment process of *kansayaku*/Audit Committee members should be?

The second point is about the use of the internal audit department. From the perspective of effectively utilizing the internal audit function, Supplementary Principle specifies that companies should ensure such coordination which the internal audit department adequately provides information to the *kansayaku* board. We'd like hear your opinions about desirable coordination between the internal audit department, the board, and the *kansayaku* board.

The third point is about external auditors. As described below, Supplementary Principles 3.2.1 and 3.2.2 stipulate steps to be taken by the *kansayaku* board and the board in order to ensure appropriate auditing by external auditors. We'd like you to discuss what steps are currently being taken by the companies, and what steps should be taken in the future.

That's all for my explanation of today's material, but we'd also like to take time to brief you on some comments submitted in response to the Council's invitation for public comments.

In connection with today's first topic about the corporate boards seeking sustainable corporate growth and increased corporate value over the mid- to long-term, we received public comments from 3 companies. All of them are foreign investment managers. First, I'll introduce comments from a UK company. Concerning independent directors, they advocated that (i) official independence criteria to be stipulated, in line with international markets, and (ii) listed companies to disclose business relationship/tenure/time lapse in a consistent manner.

They also mentioned that the board' role to be make strategic decisions, rather than concern itself with operational and minutia details.

Furthermore, they advocated that companies establish a nomination committee that is majority

independent and with the president not sitting on the committee.

Concerning the board evaluation, they said that, in order to compose the right board and promote meaningful dialogue, an external evaluation could be vital and there is no need to do this yearly, but to be done perhaps every three years. It should be done by independent evaluators, who will not impose conflicts of interests to the business.

The second commenter is a Canadian investment manager. They stated that, for effective board oversight of management, it is crucial that the board comprises a sufficient level of independent directors, and they called for a minimum of one-third independent directors on Japanese companies.

Furthermore, they advocated for the appointment of an independent chairperson of the board, and if the chairperson is not independent, the appointment of an independent lead director is critical, especially considering the predominance of insiders on Japanese boards.

The third commenter is another UK investment manager. In general, they stated that the overall level of independence of the board should increase over time, and in addition to the number and proportion of independent directors, the quality of independent directors is crucial. If a company designates a director who has trading or shareholding relationships with the company, it should disclose details of such relationships.

Next, in connection with today's second topic, we received comments from 2 organizations and 4 individuals. The first commenter is an international organization associated with corporate governance. They commented that the internal audit department should have a dual-reporting relationship to both executive management and the board of directors.

And a board's audit committee and *kansayaku* should seek to hire a skilled, strong and independent external auditor.

They said, in terms of disclosure about activities of external auditors, additional information from audit report is needed following International Auditing and Assurance Standards Board (IAASB) initiative. They refer to the so-called "long-form" audit reports. In addition to the existing format of audit reports, auditors are expected to describe additional opinions, including the key audit matter, reasons for selecting the matter, and measures to address the matter.

Furthermore, this organization stated that the Follow-up Council should address audit issues very clearly and offer guidance how to proceed with implementing and changing new corporate

governance structure, especially regarding audit and accounting.

The second commenter is a Japanese organization consisting of management executives of Japanese companies. They suggested that an act of whistleblowing should be communicated from the contact point to outside directors and *kansayaku*, and that the listed companies should disclose the summary of such a communication path or reporting line.

The third commenter is an individual, who is a board member of an academic society. The commenter stated that companies should aim at establishing and appropriately operating a whistleblowing system, and for that purpose, each company should establish Business Ethics/Compliance Committee.

The fourth commenter is a lawyer, who suggested that we should encourage companies to appoint at least one outside member with legal expertise to the *kansayaku* board.

The fifth commenter is also an individual. In order to ensure the effectiveness of auditing by Audit Committee, the Corporate Governance Code should stipulate that the internal audit function is to be enhanced.

The sixth or the last commenter is also an individual – certified public accountant. The commenter raised 3 points. First, the authority to determine the remuneration for external auditors should be granted to *kansayaku*, preferably outside *kansayaku*. Second, reporting lines between an external auditor, *kansayaku* and internal audit department should be established in such a way as to secure effective information sharing, including in the case of emergency. Finally, similarly to qualifications of directors, substantive qualifications of *kansayaku* should also be enhanced.

These are public comments we received. I apologize for my quick explanation. That's all from the Financial Services Agency in the capacity of the secretariat.

[Ikeo, Chairman] Thank you very much. Well, all the companies, which hold annual general shareholders meeting in June, have filed their Corporate Governance Reports by the end of December. Based on those reports, a representative of the Tokyo Stock Exchange (TSE) will explain the overall response to the Corporate Governance Code as well as examples of disclosures associated with Principles related to today's topics.

[Watanabe, Head of Listing Department, the Tokyo Stock Exchange] I'm going to make explanations in accordance with Materials 2 and 3. Material 2 summarized the state of disclosures in the Corporate Governance Reports, which were submitted by the end of December. As you know,

the Corporate Governance Code was implemented effective from June 1, 2015, and the disclosures have been made in the order of timing of general shareholders meetings, starting from companies which hold general shareholders meetings in June. As of the end of December 2015, 2,485 companies have made the disclosures.

The chart below shows the disclosure status by market segment. While companies listed on TSE First/Second Sections are required to either comply or explain reasons for non-compliance with all 73 principles of the Corporate Governance Code, we analyzed 1,858 companies, which already submitted their Corporate Governance Reports.

Page 3 shows percentages of companies which complied or explained their non-compliance with the Corporate Governance Code. Among 1,858 companies which are listed on TSE First/Second Sections and submitted their Reports by the end of December, companies which complied with all the principles accounted for approx. 12%, while approx. 88% of the companies provided explanations for some principles. At the Follow-up Council meeting on September 24, I reported the situations of the companies, which were the first to file their Reports by the end of August. Compared with the earlier result, the percentage of companies which complied with all the principles has decreased from approx. 60% to 12%.

Meanwhile, analyzing the breakdown of companies which provided explanations for some principles, three-fourths of the companies which provided explanations, or 66% or two-thirds of all companies complied with at least 66 out of 73 principles, or 90% of all the principles.

Therefore, including the companies which complied with all the principles, 78% of all companies complied with more than 90% of the principles.

On average, companies listed on TSE First/Second Sections complied with 68 out of 73 principles of the Corporate Governance Code, and provided explanations for 5 principles.

Page 4 shows the status of Comply or Explain for each principle of the Code. Out of 73 principles of the Code, 6 principles were complied with by all the companies. For the remaining 67 principles, there are some companies which provided explanations for non-compliance.

Compared with the result of the first-filing companies reported in September, the number of principles, which all the company complied with, has decreased from 39 to 6 as of the end of December. However, analyzing a compliance ratio for each principle, we found that 52 principles, or roughly 70% of all the principles, marked the compliance ratio exceeding 90%, meaning at least

1,670 companies complied with these principles.

The average compliance ratio of each principle is 93%.

On page 5, we selected some principles, for which many companies provided explanations. The highest explanation rate was recorded for the principle concerning the evaluation of the board's effectiveness. The second highest rate was recorded for the principle concerning the creation of an infrastructure for electronic voting, and the provision of English translation of the convening notices of general shareholders meetings. As for these two principles, the majority of the companies which already submitted their Reports chose to provide explanations.

Compared with the first-filing companies which submitted their Reports by the end of August, the same principles recorded higher explanation ratios. Overall, explanation ratios for individual principles increased. For instance, in case of the principle concerning the board evaluation, the explanation ratio has increased from 23% as of the end of August to 63% this time.

Finally, page 6 shows the categorization of explanations provided by the companies. There are 3 broad categories. In case of non-compliance with a certain principle of the Code, approx. 30% of such companies explained that they would comply with the principle in the future.

Approx. 45% of the companies explained that they are still considering whether or not to comply, and approx. 25% of the companies stated that they have no plan to comply with the principle at present.

As of the end of August, the companies which indicated future compliance accounted for approx. 50%, so the percentage has decreased by 20 percentage points since then. Instead, the percentages of the companies which are still considering whether or not to comply and those which have no plan to comply have increased by 10 percentage points each.

That's all for the explanation about the responses to the Corporate Governance Code.

Next, I'd like to briefly introduce some case examples from the disclosures related to today's discussions by using Material 3. Please take a look at page 2 of Material 3. Since the Code requires the disclosure of policies and procedures for appointing senior management and nominating directors and *kansayaku* candidates, as well as the board's view on the appropriate balance between knowledge, experience and skills of the board as a whole, and on diversity and appropriate board size, we quoted examples of such disclosures.

I'll explain only a selected example related to today's discussion. Please turn to page 8.

Page 8 shows case examples of disclosures of policies for appointing senior management. These companies disclosed their internal selection processes of senior management.

In the case of Company R, candidates for President and CEO are selected from both inside and outside the company without excluding any kind of possibilities, and are subject to deliberations by Nomination Advisory Committee chaired by an outside director and a special working group established by the Chair of the Committee from this selection stage to make a final decision.

In the next case, Company S disclosed the process for selecting new executive officers in detail, starting from the initial screening of candidates, who completed senior executive candidates training, through documentary examination and interview.

In the case of Company T, they consider it important to systematically train and nurture director candidates well in advance, in view of nominating them for senior management including President in the future. They also disclosed that mid- to long-term succession plans for key positions are periodically prepared and approved by the board.

[Ikeo, Chairman] Thank you very much. Now I'd like to open up a discussion. Today, I'd like to divide the discussion session into two parts. According to points at issue described in Material 1, in the first half of the session, I'd like you to discuss the corporate boards seeking sustainable corporate growth and increased corporate value over the mid- to long-term; and in the second half of the session, I'd like you to discuss appropriate exercise of audit functions. We have already discussed points at issue related to the board in the last two meetings, especially those described in sections 1 to 3 of Part I. So I'd like to ask for your cooperation in making your comments on these three as concise as possible, in contrast to section 4. As we have already discussed topics in sections 1 to 3, I'd like you to confirm whether you agree with what is summarized by the secretariat. As for section 4 about the appointment and dismissal of Chief Executive Officer (CEO), we have not sufficiently discussed the topic. Therefore, in addition to the points which were raised by the members and summarized by the secretariat, if there are any more points to be discussed, please raise such points. I hope we will make such discussions as short as possible, and move on to the second topic.

So if you have any comments on Part I about the corporate boards seeking sustainable corporate growth and increased corporate value over the mid- to long-term, please feel free to express opinions. Who would like to start?

[Toyama, member] I need to leave early today, so please allow me to cover Part II as well. With regard to Part I, I also believe that the appointment and dismissal of CEO, especially the appointment or succession is overwhelmingly important. Frankly speaking, there is a kind of succession that should be ruled out. That is the case where an incumbent CEO decides a successor at his/her sole discretion: he/she virtually makes a final decision on the successor by consulting with chairman, former senior advisor or so-called OB (former management); and the only one candidate is submitted to Nomination Committee or the like for its approval just for the sake of formality. Such “OB governance” should be definitely ruled out. Generally, corporate scandals occur in such companies. I’m absolutely sure about it. The existence of factions makes things even more complicated. Most of the companies in which I was involved [for corporate revival] were like that – including that airline company and Kanebo. The same could be said about Company T, which was hit by the recent corporate scandal. So such governance should be cleared away. “OB governance” is in fact rampant, so I believe that how to rule it out would be the key.

In this context, if they virtually nominated a certain person as new CEO and then such a candidate were submitted to Nomination Committee for deliberation or approval, “OB governance” would not be ruled out. Viewed in this light, CEO candidates cannot be developed in a year or two, but it requires 10 years or so to select CEO candidates, expand the pool of candidates, test them by giving them tough assignments and shuffling personnel, and narrow down the pool to the best and brightest people. Considering that the fate of the company depends on CEO, such steps should be taken. In my opinion, an emphasis should be placed on that it is important for the board members including independent directors to take such steps as fairly testing candidates from a very early stage, or offering assignments which reveal their competence, in order to narrow down the candidates. Regardless of the expression, by incorporating this point as much as possible, I consider that obscure “OB governance” would be ruled out. Actually, “OB governance” has good aspects as well. Nonetheless, simply put, a non-responsible person has certain influential power. For instance, if something happened, senior advisor could not even be sued. The situation where such people virtually have a significant influence is absolutely unhealthy. What’s more, such people will expire before CEO, and cannot take responsibility for other younger generation’s lives or future. It would be okay to seek advice of such a person, but I believe that we should rule out such an exercise of their influence. This is my first point regarding the first topic.

Let me briefly make a comment on the second topic. With regard to audit functions, the secretariat referred to the case example where a former CFO chairs Audit Committee. Although not openly mentioned, I assume that he was talking about that company. One of the executives who were arrested in the Kanebo scandal was a director in charge of finance. His title was Managing Director – either Managing Director or Senior Managing Director, I think. Looking at the case, if the company was Company with Three Committees (Nomination, Audit and Remuneration) and he chaired Audit Committee, frankly speaking, it would be like a comic: Audit Committee is chaired by someone to get arrested. Naturally, CFO is more or less involved in window dressing, or by negligence, overlooked window dressing. If such a person chairs Audit Committee, how can employees report a possible fraud to the Committee? Can you feed a former Mafia boss with information about a crime which he committed during his Mafia days? It is like a comic. So I believe that it should be clearly ruled out, too. Chairperson of Audit Committee plays a role similar to that of a police officer. It is impossible that a person who may become a thief, chairs Audit Committee, in my opinion.

It would be right to clearly specify that an independent person should chair Audit Committee. This is my second point. That's all. Thank you.

[Ikeo, Chairman] Thank you very much. I'd like to hear more opinions. Mr. Uchida, please go ahead.

[Uchida, member] As for the first part on the corporate boards seeking sustainable corporate growth and increased corporate value over the mid- to long-term, in general, I think the secretariat did a good job in summarizing various opinions expressed in the previous meetings, so that's fine as it is. Especially, the footnote about the examples of corporate efforts is excellent. It clearly states that these examples are just for reference purposes, and urges readers to keep in mind that such examples do not constitute new formal rules. In introducing the case of Kao Corporation at the previous meeting, Mr. Kadonaga also clearly mentioned that each company's specific examples reflect their efforts made in view of their individual circumstances, so even if other companies do the same thing, it will not necessarily work. I totally agree with his view. Therefore, I believe that the inclusion of this footnote is extremely important. It is important for each company to take autonomous actions in view of their specific circumstances, while looking at examples of other companies' efforts for reference purposes. I hope that individual companies would find the paper

organized in this way helpful as a reference for making their autonomous efforts.

Now I'd like to refer to a detail of Material 1. On page 1, in the middle of the 4<sup>th</sup> paragraph, there is an expression "above all else". It reads "it is necessary ... to ensure independence and objectivity above all else". I think this part corresponds to Principle 4.3 of the Code. However, the Code describes roles and responsibilities of the board in Principles 4.1, 4.2 and 4.3, and I believe that all of them are of equal importance. As described in this paper, as roles and responsibilities of the board, Principle 4.1 refers to "the establishment of business principles, etc. and the setting of strategic direction", Principle 4.2 refers to "the establishment of an environment that supports appropriate risk-taking by the senior management", and Principle 4.3 refers to "the effective oversight of the management and directors". I believe all of them are intended to be of equal importance. Since the expression "above all else" may be interpreted as an emphasis on Principle 4.3, please delete this expression, if possible.

I do not have any particular comment on the appointment and dismissal of CEO.

[Ikeo, Chairman] We have had intensive discussion on the composition and operation of the board, but I'd like to hear more opinions about the evaluation as well as the appointment and dismissal of CEO. Please go ahead.

[Nishiyama, member] My comment is not about the said points. I do not have anything to add to this paper, but this is about disclosure of information, so I'd like to see the companies explain their efforts in these areas sufficiently and clearly. I'd appreciate it, if such a remark was added to the paper.

[Ikeo, Chairman] Mr. Takei, please go ahead.

[Takei, member] I'd like to make some comments about the introductory part of the paper. My first point is the timing of publishing this kind of opinion paper. Chairman earlier explained that the Council takes into account the season for general shareholders meetings. In addition to being the season for general meetings, it is also the season for board evaluations. A large number of companies evaluate their board during the period from February to May. The board evaluation should be conducted in view of what and how the board should be. Therefore, the paper which summarizes the issues for the ideal state of the board would be important in terms of the board evaluation as well. Accordingly, I suggest that this opinion paper should be published as soon as possible at this period of time – although I'll feel bad if the secretariat has to bear a huge burden.

This is my first point.

Second, in the fiscal year 2015, roughly 2,400 companies presented their Corporate Governance Reports corresponding to Corporate Governance Code. Compared with the situation of 1 year prior to the establishment of the Code, we have seen a significant progress in substantive efforts for corporate governance by each public company, as a result of its serious consideration on good corporate governance for each company in the wake of the implementation of the Code. Therefore, it would be better to properly evaluate or appreciate such a progress, without overlooking its significance. In other words, it is not advisable to publish the paper in a negative tone by just pointing out their shortcomings. Instead, it would be better that the paper includes a positive tone by recognizing a certain progress compared to the situation of one year ago. After stating the positive part in that way, the paper should state something like “However, it is important to enhance the substance of corporate governance. The responses to the Code will not end in the fiscal year 2015. The companies still have so many things to constantly work on in and after the fiscal year 2016.” This is my second point.

From the third point, I’ll discuss the particulars. It’s related to the composition and operation of the board. First of all, concerning the composition, considering corporate governance necessary for the objectives of achieving mid- to long-term corporate growth or creating mid- to long-term corporate value, the key to substantive corporate governance would be whether the companies are actually considering the composition of the management and the board from a mid- to long-term perspectives – over 5 to 10 years. In this connection, the Corporate Governance Code already refers to sustainability issues in Principle 2.3, diversity issues in Principle 2.4, and diversity among board members in Supplementary Principle 4.11.1. The companies should clearly recognize what critical sustainable challenges they face for the creation of mid- to long-term corporate value, review whether the board has diversity of the members capable of coping with such challenges, and then consider the board’s composition. The paper should include such a message. Indeed, it is necessary to ensure diversity among both inside and outside directors/officers, but diversity required of directors should be sought only after identifying the company’s mid- to long-term challenges that need to be overcome for sustainable corporate growth. I’d like the companies to consider their substantive corporate governance in such a way of thinking. I’d like to recommend that the paper refers to such a point as one of illustrative examples, if at all.

This is applicable not only to the board's composition, but also to succession planning stated in section 4 and the evaluation of CEO. It can be evaluated whether a certain person is suitable for the top management in the future, based on what challenges the company has over the next 5 to 10 years, and what talent is required. This viewpoint is also required when independent directors engage in the appointment of CEO from an objective standpoint. So what I just mentioned is related to both the board's composition in section 1 and succession planning in section 4. Where to include such a statement is up to the secretariat. That's my third point.

My fourth point is related to the board's operations. The board should not repeat the same matters that were already discussed at the management meeting (executive board), for the sake of formality. Instead, as I mentioned in the context of the third point, I'd like the companies to consider what is worth discussing at the board meetings, in light of the board diversity. If the board meeting just repeats the same discussion as the management meeting, it will be meaningless. So they should consider what kind of diversity the board maintains, and consequently what kind of agenda the board should discuss. In addition, presenters at the board meeting also need to use their ingenuity to clarify what opinions on which aspects of the topic they want to hear from diverse directors, so they should make presentations by clearly communicating the agenda, issues to be discussed and problem awareness. I suggest that the opinion paper describes such ingenuity in discussion, deliberation and reporting as an illustrative example, if at all, in the context of the operations of the board. This is my fourth point.

My fifth point is about matters to be discussed by the board. The draft of the paper refers to narrowing down the number of agenda items. In addition to such a viewpoint, for instance, as I mentioned earlier, if many Japanese companies try to gain overseas growth as their mid- to long-term business strategy, what sustainable issues do they face in achieving such global growth? Are they ready to cope with such challenges as recent declarations by the United Nations concerning human rights, various environmental concerns, resources, and labor issues in a time span of 5 to 10 years? Japanese companies aiming at sustainable growth as global companies are being asked such questions. With regard to such sustainability issues, are management board discussions alone sufficient? Or is it necessary for the board [of directors] as the supervisory board to point out or discuss the setting of a broader strategic direction? As executive officers tend to spend much time on executing business operations as a routine, it is important for them not to lose

sight of responses to such macro-level challenges in a time span of 5 to 10 years or visions. It doesn't matter whether such matters are submitted to the board as matters for deliberation or matters for resolution. It would be case by case, but the board discusses the matters in either case. Can it be said that the management board is working on various global issues more seriously from the mid- to long-term perspectives? This would be an example of matters to be also discussed by the board from an independent and objective standpoint, and from a new perspective. It would be better to state this point in this paper as an illustrative example related to Principle 4.1 which requires the setting of broad strategic direction, or Principle 4.2 which requires the establishment of an environment that supports appropriate risk-taking.

Finally, although the draft paper refers to the appointment of directors and officers, it does not mention their remunerations. I think it is better to mention whether the remuneration structure provides incentive for healthy entrepreneurship as stated in Principle 4.2 is discussed by the board. It would be better to describe that the board should discuss the linkage with mid- to long-term corporate performance, appropriate proportion of cash and stock compensation, and so on. That's all.

[Ikeo, Chairman] Thank you very much. Mr. Oguchi, please.

[Oguchi, member] Thank you very much. First, as Mr. Takei mentioned, and as I wrote in my opinion paper for this meeting, since we've met once a month and had in-depth discussions from various perspectives, summarizing our opinions as appropriate and disseminating such information at an appropriate timing would be one of the purposes of this Council. And I think this draft is very well-organized. I'd like to thank the secretariat for their efforts, and would appreciate it if the secretariat continued to send our messages in this way in the future as well. That's my first point.

Now I'd like to make comments on the evaluation of the board effectiveness as well as the appointment and dismissal of CEO. Concerning the appointment and dismissal of CEO, as written in the paper, I believe that objectivity, timeliness, and transparency are required. As for objectivity and transparency, examples of corporate efforts are introduced. However, as for timeliness, I've been wondering how timeliness can be secured. I've been thinking about it, while reading "Boards That Lead", the book introduced by Mr. Tanaka, and listening to Kao's presentation at the previous meeting. I consider that the board needs to prepare for early discovery and early intervention: there should be a venue to frankly discuss information on a regular basis, not just after something has

happened, and on that premise, the board takes an action if something has happened. As an example abroad, the said book also referred to executive sessions – a venue for exchanging information solely among independent directors. It does not have to be formal meetings. Just getting together and briefly exchanging opinions would be fine. In case of Kao, although I don't remember if they used such a term executive sessions, he said that the chairman and other outside directors have discussions after board meetings. By frankly discussing behavior and performance of CEO on such occasions, I think that they can secure timeliness to a certain extent. Therefore, as an example of corporate effort, I suggest that the opinion paper refers to the use of executive sessions.

Next, concerning the evaluation of the board effectiveness, in the second bullet point on page 6 it reads “evaluation that includes the perspective of outsiders ... based on the experience of the United Kingdom”, and I support this statement. It also refers to disclosure of the name of an evaluation facility. I do think that such disclosure is necessary, but without a message or reason why such disclosure is required, readers may feel like it comes out of the blue. I understand that we received public comments about it: at the 4<sup>th</sup> meeting, an institutional investor suggested that in case a company engaged an external agent for the board's evaluation, they need to disclose whether or not there is any conflict of interests, etc. and a similar comment was introduced today. In case the disclosure is required for the objective of ensuring no problem with conflict of interests, before requiring the disclosure of an evaluation agent, you could explain reasons for the disclosure, such as “for the purpose of securing independence and objectivity”, so that readers can easily understand the intention. Thank you.

[Ikeo, Chairman] Thank you very much. Mr. Kawamura, please go ahead.

[Kawamura, member] As for the appointment and dismissal of CEO, I assume that a significant number of Japanese companies select CEO from internal candidates. So as an illustrative example of corporate efforts, the paper should write about the development of candidates for President. In the past, there were many cases of talent development where candidates stayed in the same division until they got promoted to the top of the division. However, that is not sufficient experience to become President in the future. Candidates, for instance, must experience tough assignments in various divisions. Boards discuss such talent development policies, which will eventually serve as guidelines. Then the companies provide various kinds of training to a group of candidates for President. It is a long journey. However, I believe that many companies will make such a journey,

and make a selection of CEO through the process described here. Currently, what Japan lacks most would be real presidents or professional presidents. It would be best to develop such talents through on-the-job training. There are not many people who have capability of serving as President of a large company from the beginning. So it would be better to develop talents in smaller companies, by establishing certain direction, policies and methods, and properly implementing them. It would be better to write in the paper that some companies have already started such a process. I believe that the scarcest resource in Japan is professional presidents. That's why I made this suggestion.

[Ikeo, Chairman] Thank you very much. Ms. Takayama, please.

[Takayama, member] I'd like to make some brief comments on the board evaluation. Since I already submitted my opinion paper today, I'd like to make 2 supplementary comments to it.

In evaluating the board effectiveness, it is important to carry out substantive and not superficial and formal evaluations. Furthermore, the board evaluation is not a one-time event, but has a nature that should be sustainably and constantly worked on. I'll talk about these 2 points.

First, I'll explain my view on substantive evaluations. The objective of the board evaluation is, as described in today's points at issue prepared by the secretariat, to establish the board capable of achieving sustainable growth and increasing corporate value over the mid- to long-term. For that purpose, the board is evaluated. Directors' performance is analyzed and evaluated from such a perspective, some performance areas to be evaluated are common across companies, and other areas may vary from company to company. For instance, one of such common areas would be the enhancement of the board's oversight functions. Meanwhile, depending on their stage of business or strategy, the focus of the board or priority of its oversight functions varies across companies. Each company needs to consider the ideal state of the board in view of its individual circumstances, and review the current state. In that light, superficial or formal checking is not sufficient. The board itself needs to have in-depth and serious discussion and review. In that sense, it would be necessary to carry out substantive evaluation, not the one for the sake of formality.

Although I said so, in reality, among companies which have conducted board evaluations, I assume that not many companies have reached that level. However, as I mentioned earlier, the evaluation is not a one-time event, but has a nature that should be sustainably and constantly worked on in order to enhance the board effectiveness. Ceaseless efforts are required. The current year's evaluation results and actions taken based on such results will be reviewed the next year, and

such a process will be repeated in the year after next, thus enhancing the oversight functions in a sustainable manner. I believe that evaluations should be utilized in this way.

[Ikeo, Chairman] Thank you very much. Dr. Ueda, please.

[Ueda, member] Thank you very much. I have 3 points to make.

My first point is about directors' induction and training, which has not really been discussed so far. On page 4 of the draft opinion paper, it is written in the fifth bullet point of item (3). The draft opinion paper briefly refers to induction and training, but I suppose that many companies are now worried about, especially for outside directors. So I hope that the opinion paper will include an additional description. Just key points would be fine.

There are several key points. The first point is the timing of providing induction or training opportunities. These opportunities can be offered at the time of entering the office as well as after entering the office on an on-going basis, and the nature of such induction or training may differ depending on the timing. The second point is the distinction of two different categories: induction or training corresponding to particular circumstances of each company, and general training in the areas such as management or finance. The third point is the resource – whether induction or training is conducted internally or utilizes external resources as well. Specific statements of these points would help the companies figure out what induction or training they should offer. Since those contribute to enhancing the board effectiveness including qualities of outside directors, I consider that we could provide a little more specific idea.

Circumstances of individual companies may change from year to year, especially in highly competitive industries. Moreover, in regulated industries such as telecommunications and financial industries, a reasonable amount of information or knowledge of the industry and regulations is required for the board member including executive and non-executive. Taking such aspects into consideration, the provision of such perspectives as specific examples of training would serve as practical guidelines for corporate efforts. Furthermore, if it leads to making disclosure, it will be helpful for investors to understand the efforts by each company.

Second, according to the structure of this draft opinion paper, it's on the same page 4 about the evaluation of the board. As there is an overlap with my comment at the previous meeting, I'll make it concise. In order to make an evaluation, they first need to clarify what the board should do - in other words, roles and functions of the board, and then evaluate its effectiveness in terms of

performing such roles and functions. I'd like the companies to show such a consistent story. For that purpose, I suggest that the opinion paper contains this point. Then it will probably become clear that what is questioned is the effectiveness in the substantive sense, not the formal one which is measured by such elements as the number of attendance in board meetings or statements made, I suppose.

Finally, my third point is about roles of CEO and the appointment/dismissal of CEO. I'd like to tell you what issues are commonly discussed in dialogue between investors and companies in the UK, which implemented the corporate governance code earlier than Japan. The most common issue or the 1<sup>st</sup> place of top 5 ranking was remuneration, followed by strategy in the 2<sup>nd</sup> place, CEO's functions in the 3<sup>rd</sup> place, the board and committees in the 4<sup>th</sup> place, and succession planning in the 5<sup>th</sup> place. Two CEO-related issues were ranked in the top 5: CEO's functions (3<sup>rd</sup> place) and succession planning (5<sup>th</sup> place). What we can see from this result is the fact that issues on CEO are strategically important. The traditional Japanese style of succession, which the current CEO assigns the successor, is not acceptable any longer, and an objective and transparent process is required. I'd like to suggest that the paper emphasizes or clearly states that a decision on the appointment and dismissal of CEO should not be made in a closed room, in terms of awareness-raising. Thank you very much.

[Ikeo, Chairman] Professor Kawakita, please.

[Kawakita, member] I have 3 points to make. The first point is about the composition of the board on page 2. That section refers to independence and objectivity, and also mentions diversity. However, in order to ensure diversity, the board may include members from entities with business relationships with the company. Then it conflicts with independence. In case there is a business relationship, as Mr. Toyama mentioned before, there is a question of whether such an outside director can challenge others, even if it may lead to his/her removal from office. It's not just about his/her own removal from office, but also potential termination of business relationship with the organization which such an outside director belongs to. In this sense, the board cannot play expected roles in that connection. Therefore, it is possible that a person from an organization with a business relationship is appointed as a director, but in that case, in order to ensure functions of outside directors, they need to appoint independent director(s) as well. As a result, the total number increases. That's a possible mix, I think. Simply put, I'd appreciate it, if the paper included some

cases of conflict between independence and objectivity/diversity, and need for measures to mitigate such a conflict.

Next, I'd like to talk about agenda items in relation to the operation of the board on page 3. As I mentioned at the last meeting, I believe that the board should discuss mid- to long-term strategies as a broad topic. However, to do so, the board also needs to discuss which stage the company is currently at, to figure out a mid- to long-term direction. It may be a matter for reporting, rather than a matter of deliberation. All listed companies close the book and issue monthly financial statements, so such financial results are to be reported to the board on a monthly basis. I believe this is an important role of the board. In addition, by reviewing monthly financial statements, the board can find not only the current stage compared to its mid- to long-term business strategy, but also sudden improvement or decline in corporate performance, and discuss it accordingly. Considering the "Company T", I think that it works as a check function.

My third point is concerning the appointment and dismissal of CEO. The text seems to have been written with internal candidates in mind. At the moment, it may be almost inevitable to appoint CEO from inside the company, but recently, there have been some cases of appointing CEO from outside the company. Therefore, it is necessary to look not only at internal candidates, but always seek more appropriate candidates outside the company, and I think that the board needs to keep it in mind and have discussions at a certain point of time. That's all.

[Ikeo, Chairman] Thank you. Mr. Tanaka, could you?

[Tanaka, member] I'm all for issuing the opinion paper this way. The timing is also very good. In the first place, in the last part of the Preamble of the Corporate Governance Code, it refers to future revisions of the Code. So it is quite appropriate to deliver to the public our view of how we now look at the Code.

I'd like to raise 2 points. One is related to TSE's material, so I'm afraid that I go off the track. Material 2 shows corporate responses from various angles. For instance, page 4 shows the status of Comply or Explain for each principle, and most principles marked the compliance ratio exceeding 90%. As I've worked in the financial industry for a long time, I have a habit of looking at figures with suspicion, and wonder if these compliance ratios are true. All of them are based on their self-evaluations. I'm wondering whether it is right for the Council to evaluate that the companies have made this much progress by merely looking at these figures based their own evaluations. I

have a doubt about the reliability. For example, let's look at Principle 4.3. We discussed it in the last meeting as well. It is reported that 1,830 companies or 98.5% of all companies complied with Principle 4.3 which is the 41<sup>st</sup> principle, which requires an 'independent and objective' standpoint, which is one of the focuses of today's discussion. I'm wondering if boards of these 1,830 companies really maintain independence. According to the previous explanation by the TSE, as said before, on average among the companies listed TSE First Section, the board consists of 7 inside directors and 2 outside directors, totaling 9 directors. In such a situation, I wonder if 1,830 companies really consider that their boards maintain independence. Then how can we identify the reality of the situation? Maybe we should turn to the Stewardship Code. Principle 3 of the Stewardship Code stipulates that institutional investors should monitor investee companies so that they can appropriately fulfill their stewardship responsibilities, and principle 3-3 refers to a variety of factors to be monitored, including corporate governance and other non-financial factors of the investee companies. So there remains a task that institutional investors check whether these figures are really correct. This is my first point. Among engagement with investee companies, I believe that this should be a very important one.

The second point is about the appointment and dismissal of CEO in section 4 of the paper. I feel there may be a huge difference between the appointment and the dismissal, although the paper discusses the appointment and dismissal together. Including earlier-mentioned talent development and succession planning, I think this is a crucial point. For instance, suppose they say, "Our Nomination Committee interviewed the candidate a couple of times, and therefore, we appointed him." This is just formalistic. Meanwhile, some companies make such decisions by spending several years. Considering such a situation, it would be very important how much time and energy they spend on this process. And when making a final selection from candidates, it would be necessary to make such a selection in consideration of the mid- to long-term business environment and a direction of business strategy. I think that's the way it should be.

In contrast, I consider that the dismissal is a totally different task. It is an action which may be regarded as if there were infighting in the company, so I think it needs to be considered separately.

To properly carry out a dismissal process, as other members also mentioned, I think the board itself must be certainly independent from the management. When we discussed independence during the last meeting, the TSE defined it means "independent from the management". In that

sense, although the paper states a “mechanism where the board can dismiss CEO”, I feel this point should be discussed more specifically from a different perspective, instead of discussing the appointment and dismissal together.

[Ikeo, Chairman] Mr. Iwama, please.

[Iwama, member] First of all, I also believe that it is very good to summarize and publish our views at this timing. I also want to talk briefly about the issues on CEO including the dismissal, as well as the issues of the board evaluation. Concerning the issue of CEO, as Mr. Kawamura also mentioned earlier, the point is how many qualified candidates the companies can secure. Not just one candidate, but a pool of candidates. They need to carefully consider how they develop candidates with what qualifications, and it is important that all the board members have a clear understanding about it. If a candidate recommended by an incumbent CEO were eventually found to be the most appropriate, it would be important to demonstrate the justification of such appropriateness.

I also consider that the nature of the dismissal is completely different from that of the appointment, as Mr. Tanaka pointed out. Looking at examples of the UK companies which I actually know, it is common in the UK that the roles of the board chair and CEO are completely separated. Basically, if investors are in doubt about CEO, they usually go to talk with the board chair or leading director. Instead of doing it hastily, naturally they need to claim that dismissal of CEO is adequate from a wide variety of angles and from an objective standpoint. Then, considering the current board’s composition in Japan, can the board do it properly? The answer is not always yes. Therefore, in that sense, probably it would be necessary to consider what can be done in the current situation of Japan to take a step forward.

As for the evaluation of the board’s performance, unless self-evaluations are properly carried out, there will be conflict with third-party evaluations. Third-party evaluations are just for reference. Boards itself should conduct self-evaluations in such a way as to clearly explain what roles the boards have, and how they performed over the past years or every year; and then external organizations attest such self-evaluations. I think that such a flow is desirable.

I have one more thing to tell you about talent development. Even in our asset management industry, we are not necessarily sure how CEO should be appointed, or what kind of person is really qualified for the position. Even though we are in a position to engage with investee

companies, we will be embarrassed at being asked whether we are doing it properly. Now I'm coming to the point. The Stewardship Code and the Corporate Governance Code are complementary like two wheels of a cart. The TSE reported high compliance ratios about the Corporate Governance Code, but what about the reality? While being in a position to follow the Stewardship Code and engage with the companies, what are we doing? These are quite well-directed questions. Our association [Japan Investment Advisers Association] is now conducting a follow-up survey of the members. This time, we included some questions which asked respondents to provide narrative explanations of specific cases. If we disclose such answers as they are, many concerns will arise. So we are wondering how to disclose the results. I think that it is necessary to run on two wheels with the results of the survey over time, and we take it seriously.

[Ikeo, Chairman] I don't mean to drop this topic, but it's time to open a discussion for the second topic. I'd like to wrap up discussions on Part I. Basically, the logic flow would be as follows: the objective is to seek sustainable corporate growth and increased corporate value over the mid- to long-term; to achieve the objective, the companies need to identify what qualifications or competencies are required; and appoint directors and CEO with such qualifications or competencies. Required qualifications or competencies are defined first, and then people who meet such requirements are appointed. Accordingly, if such candidates cannot be found within the company, there will be an option to find them from outside the company. I think that is the flow of our discussion.

Now I'd like to hear your opinions on Part II concerning Appropriate Exercise of Audit Functions, which we have not discussed sufficiently in the previous meetings.

[Callon, member] May I still make a comment on the first part?

[Ikeo, Chairman] Sure, please go ahead.

[Callon, member] Sorry for the interruption, and thank you. I'll make it brief. With respect to board agenda-setting, if the board chair sets agenda items at his/her sole discretion, in reality it means the chair alone is largely driving board outcomes. For example, if a significant matter is presented by the chair to the board by saying, "Today's second matter for resolution is XYZ, and a draft of the press release is per the attached," this is a call for board approval, not for board deliberation. The board should not merely be a vehicle for saying yes or no to matters submitted by the chair. Instead, the board should ensure that independent directors fully represent the views of

minority shareholders. For that purpose, it is important for the board to establish a system to foster active discussion by soliciting agenda items from independent directors. For proper board functioning, it is essential for the board to fully discuss matters which the independent directors have doubts about or find problematic, so I'd appreciate it if our opinion paper could include independent directors independently putting items on the board agenda as a best practice in "Examples of Corporate Efforts". Thank you.

[Ikeo, Chairman] Thank you very much. I'm sorry to have rushed you. Now we move on to Part II concerning appropriate exercise of audit functions. For convenience of discussion, we occasionally used such terms as "offensive governance" or "growth-oriented governance" versus "defensive governance". Both sides are related, but now I'd like to hear opinions on the defensive side. Professor Kawakita, please open a discussion.

[Kawakita, member] I consider that audit functions are very important. In a company where I serve as an outside director, there is the *kansayaku* board. As I mentioned before, I find the exchange of opinions with *kansayaku* very useful. It is partly because there is a full-time *kansayaku* who constantly looks at the situation of the company. Speaking from the standpoint of an independent director, no matter how many training opportunities are provided, there is a limitation. So the presence of people who always look at internal affairs of the company is very helpful.

Then how the *kansayaku* board should be composed? As written on page 6, considering who should chair Audit Committee, as Mr. Toyama mentioned, it is not appropriate that a person like a former CFO chairs the committee. It does not matter if such a person serves as *kansayaku*. Rather, appointment of an inside member or members as the *kansayaku*, who knows internal affairs of the company extremely well, not limited to CFO, has significant implications. However, the top of the *kansayaku* board should be independent, and assume such roles as deciding on agenda items for the *kansayaku* board meetings and how to organize discussions. As a result, various kinds of internal information flow into the *kansayaku* board, which in turn, discusses or examines such information and reports results to the board or independent directors. That is important.

Another point is about the audit department. It is important that the audit department not only conducts internal check and gather information, but also reports such information to incumbent CFO and/or CRO. CRO is in charge of risk management, including compliance. As pointed out in a public comment, it is true that compliance is also important. I mean that it is important to perform

not only accounting auditing, but also compliance auditing. And such information should be reported to CRO. The reporting lines to CFO and/or CRO, and also to the *kansayaku* board are essential. I consider that the role of the *kansayaku* board or the audit department is to directly gather internal information and report it to upper layers. That's all from me.

[Ikeo, Chairman] Thank you very much. Mr. Kawamura, please go ahead.

[Kawamura, member] On page 6 of the material, it refers to the utilization of and cooperation with the internal audit department. I'd like to say these are very important. In relation with this topic, in our company, 3 parties are involved: Audit Committee within the board, the internal audit department, and external accounting auditor. In terms of information sharing and cooperation among these 3 parties, we consider that cooperation with a sense of tension is very important. If these 3 parties act in an uncoordinated manner, proper assessments will be hardly made. In our case, Audit Committee and the internal audit department work very closely in terms of the setting of direction. Based on an overall direction set by Audit Committee, the internal audit department looks at details. And they exchange information with external accounting auditor, share risk information, and share various reports, as mentioned earlier.

Therefore, to avoid a situation where these 3 parties act in an uncoordinated manner, it is very important to ensure very strong cooperation, but with a sense of tension: each party acts with a sense of tension from its own standpoint. Especially in Japanese companies, we believe that the internal audit department is extremely important. For example, in our view, it would be an option that in the course of developing CEO candidates, the internal audit department can be utilized. If a CEO candidate has stayed in the same department, he/she should be assigned to the internal audit department, for instance, for a year, while he/she is young. He/She can learn business conditions of approx. 3 divisions within the group during such an assignment. Not to uncover a scandal, but to understand business conditions, because he/she conducts management auditing. In that way, while he/she is relatively young, he/she obtains an understanding of divisions, while checking debit and credit slips in detail. I believe that the internal audit department is so extremely important that it can be used even in such a way. It is the role of monitoring various divisions on behalf of President.

Therefore, the department reports directly to President. In that context, as I feel the internal audit department is rather neglected, I'm making this comment. It would be very good to write in the paper that cooperation among these 3 parties, including the internal audit department, with a

sense of tension is important.

[Ikeo, Chairman] Mr. Tanaka, please.

[Tanaka, member] I totally agree with what Mr. Kawamura just mentioned. This may be about technicality, but I think that it is necessary to consider the definition of audit. There is a term quadripartite or four-way audit as well. Anyway, considering audits of Companies with *Kansayaku* Board, and audits of Companies with Three Committees, I assume that contents of these two audits are significantly different.

In case of the US and the UK, or the Anglo-Saxon model, the term “Audit Committee” is used. I understand that the Japanese model originated from the German model, and then was significantly modified in a Japanese way. I suppose that it initially started in view of supervision. So I assume that these two models are very different.

The reason why I’m talking about such a point is because it was one of the major issues when Mitsubishi UFJ Financial Group (MUFG), where I worked, changed its organizational form to Company with Three Committees. *Kansayaku* is basically an independent agent who acts on one’s own responsibility. Our group also had full-time *kansayaku*, and they carried out a significant number of site visits, and sometimes obtained very good information from the sites. However, it was almost impossible for 3 or 4 *kansayaku* to audit the company where 140,000 people work and to discover all the problems everywhere. Naturally, if any problem occurred, it is possible that *kansayaku* did not visit there. Furthermore, sufficient resources were not really provided to *kansayaku*. In that light as well, there were many challenges for *kansayaku* to monitor all the businesses.

In addition, as often said, in case of *kansayaku*, their main focus is to detect illegal acts of directors through audits, and they hardly expand the focus to appropriateness. There are various arguments about this point, but when that’s the case, the current job of *kansayaku* has limitations in various aspects including resources and the scope of duties. We now adopted the form of Company with Three Committees. In case of this form, audits are conducted by Audit Committee, the scope of which is broader so that overall management is subject to audits. In addition, since there is no limitation under the Companies Act, the Committee can conduct audits not only to detect illegal acts, but also to check appropriateness. Furthermore, I assume that every company has the internal audit department. The Committee can use such a department as its staff members, so it can carry

out audits in a broader scope.

Therefore, our Group decided to change its organization form in order to place more emphasis on the importance of auditing. The paper refers to the utilization of the internal audit department. I assume that it is such an organization as Audit Department. Recently, the English term “compliance” has been increasingly becoming important everywhere. Compliance is translated into the Japanese term equivalent to legal compliance. However, in reality, management audit functions can no longer be performed without making judgment of appropriateness beyond legal compliance. In that sense, functions of the internal audit department as described here, auditing by the board or Audit Committee, and auditing by *kansayaku* are different from each other. On that premise, each company should consider how to assemble them. I feel that the paper needs to make this point clear.

In the meantime, I do believe that, as Mr. Kawamura mentioned, information sharing and cooperation among these parties are absolutely important.

[Ikeo, Chairman] Personally, I have a question. Who should lead the internal audit department? Or who should be the owner of internal audits? You mentioned that the internal audit department reports directly to President, and the majority of Japanese companies have such a reporting line. In that case, when CEO is the owner or supervisor of the internal audit department, if there is any corporate scandal which CEO is involved with or wants to hide, I’m wondering whether the internal audit functions really work. I’d like to know how we should consider such a fundamental problem.

[Tanaka, member] That’s also a critical point. In our case, as you know, we have built an alliance with Morgan Stanley, where Chief Auditor reports to both CEO and Audit Committee. And Audit Committee has the authority to appoint and dismiss Chief Auditor. It would be unacceptable, if CEO did not know information from Chief Auditor. On the other hand, the flow of information will not stop there. Such a double reporting system would be one of wise solutions.

[Ikeo, Chairman] I’d like to hear more opinions. Anybody wants to share opinions? Mr. Callon, please.

[Callon, member] I agree with Mr. Tanaka. Internal auditors should report directly and simultaneously both to the CEO and to the full board. Thank you.

[Ikeo, Chairman] Ms. Takayama, please.

[Takayama, member] I'd like to make a supplementary comment. Looking at case examples abroad, for instance, Singapore's Governance Code stipulates that the internal audit department reports principally to the chairperson of Audit Committee, and it is Audit Committee which approves the appointment/dismissal of the internal audit department head as well as personnel evaluation. In the UK, although the UK Code does not stipulate it, the FRC's Guidance on Audit Committees includes a similar statement. Therefore, in Europe and Asia, and maybe in the US as well, it is considered important that the internal audit department reports not only to CEO, but also to independent directors, and that actually is a common practice.

[Ikeo, Chairman] Mr. Uchida, please.

[Uchida, member] Thank you. I would like to discuss our general approach. If we are going to discuss the appropriate way to fulfill the auditing function based on instances where it failed, I believe that first of all it will be important to determine the reasons for such failures besides looking at the root causes, and start out with a shared understanding of the reasons for such failures among us. Unless we do so, we may end up with a discussion that is not based on fact, or based on mere suppositions derived from personal experience. It is my hope that we are able to move forward with a shared understanding of where the true issues lie. We won't be able to achieve this goal today, so I will leave it aside for now, but nevertheless it is what I hope for.

Let us then look at the second bullet point at the top of page 6. It reads, "the *kansayaku* board is the very kind of organization that should be entirely composed of independent people." I think a thorough grasp of internal information would help the *kansayaku* board carry out its audits effectively, and therefore the presence of internal or full-time *kansayaku* or audit committee members will be extremely important. If all members are independent, instances of misconduct may, in some respects, prove harder to identify, and I think such an approach would be too radical.

Many, however, have voiced the opinion that, since internal personnel would be appointed to the position of *kansayaku* by the CEO, the CEO would then have authority over appointments, such *kansayaku* would be unable to curb misconduct or abuse of power on part of the CEOs. It is, however, the *kansayaku* board's intended function to deal [with any issues] by gathering plenty of information from within the company, either directly or indirectly, while independent *kansayaku* fulfill their role thoroughly. By doing so, I believe that misconduct and abuses of power on part of the CEO can be prevented. Accordingly, I believe the qualifications of independent *kansayaku* to be

extremely important, just as are those of independent directors. It seems to me that the numerous instances of misconduct that have occurred suggest a weakness in this point, and that the presence of a *kansayaku* board may have been treated as a matter of mere form. This is just a supposition, mind you.

Accordingly, I think ascertaining the qualifications of independent *kansayaku* may be more important than simply increasing their number. *Kansayaku* appointed from within the company are highly capable of acquiring information. I think Professor Kawakita was right earlier on. *Kansayaku* from inside the company are thoroughly familiar with the actual conditions, and they have unlimited time at their disposal by virtue of serving in a full-time, non-executive capacity. Furthermore, they hold great authority of investigation under the Companies Act, are allowed universal access, and can attend all important meetings. They are thus capable of acquiring a comprehensive grasp of all decision-making and all processes involved, so I believe it will be key to make use of *kansayaku* appointed from within the company. In other words, I think it will be important to set up effective *kansayaku* boards by utilizing *kansayaku* appointed from within the company as well as appointing those who are qualified to serve as independent *kansayaku*.

Next up, the first bullet point in the part enclosed by a square on “the appointment of *kansayaku* and audit committee members” discusses cases in which someone with CFO experience is appointed as head of the audit committee. The CFO's intended role is to serve not only as adviser to the CEO, but also as the one to hit the brakes when necessary. Accordingly, it may be different in the case of audit committee chairs, but I feel that it might be an exaggeration to say that CFOs should never serve as *kansayaku* or audit committee members. On the contrary, I believe there may be cases where *kansayaku* or audit committee member functions effectively by leveraging such expertise. It will be necessary to accurately gauge the composition of the *kansayaku* board as well as the policies adopted when appointing *kansayaku*. For example, I believe that in this respect it may be possible to find ways to make good use of optional committees. I'm afraid that categorically excluding the possibility of persons having previously worked as CFO serving as *kansayaku* or members of the audit committee would be something of an exaggeration.

[Ikeo, Chairman] Mr. Oguchi, please.

[Oguchi, member] Thank you. At our previous meeting, I discussed the opinion voiced by a foreign investor to the effect that it should be the *kansayaku* board to fulfill the role of a third-party

committee. I have spoken with this person again, and I think I got a sense of what he meant by that. His point, mentioned in the course of today's discussion as well, was that the party gathering information should be separate from the party taking the final decision. As Mr. Uchida has mentioned, information is held by those inside the company, and it is important to gather it in sufficient amounts from such sources. There has been talk of coordination among different parties in order to achieve that goal, but the investor I mentioned believes that it should be the committee to take the final decision on the basis of such information. His argument is that, at this stage, it would hardly be feasible to guarantee the fairness of a final decision without the decision-making body's independence. He therefore maintains that we should make effective use of internal audit departments to gather information, without the necessity for all involved parties to be independent, and that decisions should be made on this basis by the audit committee, composed, if not completely, by a majority of independent members. He maintains that this is especially true of reporting, which should ultimately reach the independent head of the committee. I do not think we would be able to verify the correctness of this approach through discussion here without a grasp of actual conditions, as on the one hand some argue that information will not be passed on without someone from within the company, but there are also instances overseas in which audit committees composed of independent members are able to function successfully. For example, I think that one way to go about this would be to try and learn how it is that foreign audit committees made up almost exclusively of independent auditors can function, and take it from there.

I myself had always thought that having internally appointed members on the *kansayaku* board would be the more effective approach. I have discussed the fact that audit committees in Japan function with the presence of internally appointed members with global institutional investors, who believe that audit committees should be made up almost exclusively of independent members, and that this should be the case for the committee head in particular. But when a third-party committee is set up after a corporate scandal, it is able to dig up information in spite of being composed of external members only, and to eventually produce a detailed report. I thought that, if decision-making is possible in this fashion, it must have to do with the way in which information is gathered, and with rigorous separation from the body that eventually takes a decision based on such information. So to reiterate, I think it may prove valuable to study instances in which foreign companies employ audit committees made up of independent directors.

[Ikeo, Chairman] I also have very little knowledge of the matter, but I hear that internal auditing in countries such as the UK and the US is a more specialized line of work. As someone mentioned earlier, in Japan members of management serve in rotation as internal auditors as part of their career path. I would think that overseas they have more specialized people, or at any rate professionals of some sort appointed to positions in the internal audit department, and that the audit committee is supported by such people in its decisions.

[Tanaka, member] I agree. But in a word, the starting point for any audit naturally lies in the ability to read and understand financial statements - to look at figures, that is. Of course it's also necessary to gather a variety of information, but it's here that the basis lies, and this makes auditing a job for professionals. I think auditors have a strongly grounding in this respect.

[Ikeo, Chairman] Please go ahead.

[Kawamura, member] Members of internal audit division at our company are professionals as well, with only a few people who are not trained as auditors, and are studying auditing in rotation as part of their career path as I mentioned earlier on.

[Ikeo, chairman] Would anyone like to further remark on this point? Mr. Takei, please.

[Takei, member] I would like to make a few comments in relation to what we have discussed just now. First of all, with regard to the part of the paper discussing the appointment of *kansayaku* and committee members, this can be treated as an issue of how to deal with conflicts of interest among *kansayaku*, audit committee members and supervisory committee members. With officers in charge of auditing under the Companies Act and other persons appointed to serve as non-executive officers, there is a possibility of conflict of interests arising from their past job descriptions and current business relations. Let us assume, for example, the presence of some sort of conflict of interest involving individual *kansayaku* and committee members when they are five. In such cases, the four other people should be aware of the conflict of interest in which a given other *kansayaku* or committee member is involved, and decide the scope of work that he or she is to be assigned to accordingly. It is not a good idea, however, to prohibit people with certain conflicts of interest from being *kansayaku* in the first place. It is an issue of how the other four people, who are aware of the potential conflict of interest, should cover the role of that person in an independent and objective fashion. Whether or not those with CFO experience should be able to serve as committee chairperson can be the subject of discussion. But, I think most cases can be appropriately dealt

with the actual conflicts of interest. The problem of how to deal with conflicts of interest involving non-executive officers has long been discussed under Japanese corporate law with regard to people being appointed to serve as *kansayaku* immediately following the position of director. I think that audit committees, *kansayaku* boards and supervisory committees should, at their respective meetings, raise and discuss the question of the emergence of conflicts of interest in conjunction with the transition from the position of director to that of auditor. This is the first point I would like to make.

My second point concerns the words “internal audit departments” in this paper. Some companies treat their internal auditing department in the strictest sense of the word. For the purpose of our argument in this paper, however, the internal audits may include all business functions related to working on the front line of business and prevent the company's execution of business from resulting in something that is detrimental to society at large. Accordingly, it is advisable to state in the paper that the words “internal audit department” includes not only the internal audit department in the strictest sense, but, rather, a variety of different departments to fulfill the internal auditing function, such as the legal department, the accounting department and others also have a function as the internal audit department in a substantive sense. This was the second point I wanted to make.

My third point is that I am in agreement with what Mr. Kawamura said earlier. In short, providing motivation and incentives for the staff of the internal audit department will be practically important. In addition to the professional pride of internal audit staff, it will also be necessary to ensure that they are aware of the importance of their role, including that a position at the internal audit department of one's company is part of an internal promotional track. Also, providing them with this type of promotional motivation would help foster an atmosphere or incentive for people to provide internal audit department staff with information. As Mr. Kawamura said, it would be a good idea to appoint young candidates for the position of president to the internal audit department in the course of their training.

In addition, these topics are thoroughly discussed in Code of Kansayaku Auditing Standards published by JASBA, which illustrate various best practices. There remains the issue of how such practices should be implemented by both executives and non-executives. I think it may be useful to make reference to the JASBA's Code of Kansayaku Auditing Standards.

[Ikeo, Chairman] Please go ahead.

[Callon, member] The ex-CFO of a company serving as the head of the audit committee, which is meant to audit the full scope of corporate management and corporate activities can hardly be thought of as ideal from the standpoint of audit reliability. As highly capable as the ex-CFO may be, the possibility of a conflict of interest is undeniable, because an audit by its very nature has historic elements: what happened when the ex-CFO was serving as CFO could be a critical audit point in understanding today's situation. I don't think there is a problem with an ex-CFO serving as an audit committee member, but serving as audit committee chair is inappropriate. By the way, the ex-CFO serving as audit committee chair was precisely the case at Company T. An independent director should serve as the head of the audit committee. This is essential to robust governance.

[Ikeo, Chairman] Professor Kawakita, please.

[Kawakita, member] I would like to make a brief addition. Mr. Takei has discussed how it is a problem to consider the internal auditing department in the strictest sense of the word. As far as I know, in a sense the internal auditing function is an organization. In other words, the internal auditing function is not performed by only one department, but by personnel dispersed across the company. This means that people in charge of parts of the internal auditing function are present in different departments, and so that it may be more appropriate to think of the auditing function as an organization rather than as a single department.

Furthermore, those affiliated to the organization will be handling an extremely diverse range of operations. I think industrial companies require wide-ranging professional expertise, not only in Japan but also when expanding abroad. In such occasions, experienced employees could be affiliated to the internal auditing function in some cases, and that an auditing role could be treated as part of a career path in terms of developing human resources in some cases. In this sense, it is my understanding that the status and importance of those in charge of the auditing function will inevitably be on the rise, and I felt I should add this.

[Ikeo, Chairman] Would anyone like to comment? Please.

[Nishiyama, member] The topics discussed up to this point have often included, for example, the qualifications of outside *kansayaku* and outside directors. However, having listened to what has just been said, I do believe that it is highly necessary for us to review and clarify the qualifications and sense of ethics of people involved in that department within a company. I think we should discuss

these points and put it all together.

[Ikeo, Chairman] Professor Kanda, please go ahead.

[Kanda, member] Thank you. I'm not sure I am following the discussion, but I would like to bring up two points on which I am not clear, as well as one general remark. The first point that I am not sure I understand would be what is meant by "audit committee" as mentioned earlier - overseas, that is. I have no direct knowledge at all, but as far as I can tell based on the materials, in this case "audit" means an accounting audit, and further, the committee does not conduct the audits itself, but rather has other parties conduct the audit - namely, external auditing firms or an internal audit department. So I do not mean to repeat what Mr. Oguchi said earlier on, but I would conclude that audit committee members can be part-time, or at any rate there is absolutely no need for them to be appointed full-time. I seem to understand that this is common practice globally. In Japan, some maintain that audit committee members must be appointed on a full-time basis because they conduct the audits themselves. Appointment to full-time positions is not a bad thing by any means, but I think that if we do not clarify what it is that auditors should do themselves and what it is that they should instead delegate, we will not be able to find an answer to the question raised by Mr. Oguchi earlier on.

The second point on which I am not clear is - I'm not sure how to put this - whether it would be better to talk about times of emergency and normal times. In Japan, it is my understanding that we tend to make plans and do things in a very systematic fashion throughout the year, be it the work of an internal audit department or the conduction of an audit. If we treat such a state of affairs as "normal times," it will be a different matter when something happens to get things in motion. And if we refer to the latter state of affairs as an "emergency," this will now require crisis management and differ from normal times in a variety of ways. The two situations may be not be completely unrelated, but are nevertheless different, and I feel that this should be briefly clarified in writing.

Also, I may be a little late in making this point, but I would like to bring up an overarching point that I am not too clear on. This has already been mentioned. With regard to material 1, while I do believe that it extremely positive that we formulate proposals and report at this meeting, I am not completely convinced. Let me explain myself. As Mr. Tanaka has mentioned, the Code has been created, and a report on the Governance Code have subsequently been issued. So I believe that any proposals should be formulated upon stating our evaluation of these facts. I feel that we would be

leaving something out if we do not do so. So now that we have the Code, 1,800 companies have either complied or explained as was discussed today. How are we to evaluate "explaining"? Also, should we interpret this as something that is conducive to dialogue with investors? I think such an assessment would make for an extremely smooth transition to Material 1. As someone pointed out, something similar can also be said concerning the Stewardship Code. I do not know how many organizations have "explained" concerning the Stewardship Code. However, this leads us to discuss the fact that the board of directors can only play its role effectively on the basis of an assessment of those matters that have been explained and those that have not. If this aspect is missing, as Mr. Tanaka has pointed out, the Code will merely stop at the "comply" stage. I think making unilateral suggestions on our part may lead to a rather poor transition, and I think it would be preferable to add in the missing step.

[Ikeo, Chairman] As Mr. Takei also mentioned earlier on, the first paragraph of Material 1 merely mentions that a great change has come to pass. It does not present a qualitative assessment of whether such change is desirable or insufficient. As you have pointed out, this will require further review from the next meeting onwards. We will need to have the secretariat take care of the review, as I do not believe I can handle everything myself. (laughs) Please go ahead.

[Mr. Tanaka] The point that Professor Kanda has brought up - namely, that the audit committee does not carry out audits itself but instead delegates their conduction to other parties - is an extremely important, major one. Consequently, Japanese companies have given the matter some thought, and many have recently appointed a board of directors' audit committee by non-executive full-time members. In a sense, the advantages of having full-time *kansayaku* lie in their direct involvement in audits. At larger companies, however, even a full-time auditor may not be able to oversee everything. The "delegating" part is also important, and I completely agree with the idea of involving internal audit and legal affairs departments. I feel that a hybrid approach may be on the rise at Japanese companies - ours included - whereby a firm overall grasp of the situation is developed through such departments.

[Ikeo, Chairman] Mr. Iwama, please.

[Iwama, member] As Professor Kanda pointed out earlier on, I also think there is a tendency for numerous companies to "comply" and I also feel that we would be leaving something out. But if we look at examples in the UK, every year the FRC issues a review, and while companies complying

in good order where extremely numerous at first, the ratio they occupy has in fact gradually fallen over time. It is my impression that this is a step forward instead of a form of regression. So when there are new codes in place, at first everybody is going to do their best to comply, albeit in form only. I think an action that we will face in the future will be the timing and duration of review [like that issued by the FRC]. I think that much like wine, the system will mature as time goes on. This is not the sort of issue that can be completely broken down and settled logically to begin with. I believe that with this sort of concern, it is important to allow for value to gradually spread around. I also think we should consider the state of compliance with the Stewardship Code that our association [Japan Investment Advisers Association] surveyed, and how to release information to the public.

[Ikeo, Chairman] Mr. Kawamura, please.

[Kawamura, member] As we have come to discuss the way in which the report is going to be issued, I would like to ask a question. I think JASBA is engaged in discussions quite similar to ours, and The Japanese Institute of Certified Public Accountants, too. Their focus may be a little different, but I'm wondering about how we should relate to their respective ongoing discussions. In other words, should we discuss the issue and publish our results independently, or should we compare our thoughts along the way, if not go as far as adjusting our mutual views?

[Ikeo, Chairman] Mr. Kawamura, please.

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[Ikeo, Chairman] What do you think?

[Mr. Tahara, Head of the Corporate Accounting and Disclosure Division] I think this is up to those in attendance today. Generally, I think of discussions at this venue as taking into account such matters. In case you would prefer to contact people from these associations and exchange opinions, we may for example invite them this at our next meeting. As pointed out earlier on by Professor Kanda, some points are missing in the text on Material 1. However, as I have reported today,

analysis did show that the rate of compliance is now quite high, as a matter of form. The compliance rate has remained high since our first data analysis, and I believe that the rate will decline as explained by Mr. Iwama. All attending members share the view that the issues lies with the practical aspect of compliance. The areas to be focused on in this regard have been the subject of discussion at the past three meetings or so. Nevertheless, I am sorry that the explanation provided in the materials was insufficient. We hope to hear your opinion on how to rearrange the materials, and to change the way in which we prepare our materials accordingly. I look forward to hearing your opinions on how to compile the materials.

[Ikeo, Chairman] For the time being, I believe the materials are being prepared independently. We will consider further collaboration over the mid- to long-term as the need arises.

Mr. Nishiyama, I don't believe you have anything to add?

Then today we can finish on schedule. This is not, however, the end of our discussion. Since we have had a thorough discussion of issues concerning the Board of Directors and its role the over the past three meetings, unless you have any objections, from the next time onwards, as I have previously mentioned and in view of the members' opinions, I would like to compile a opinion statement on issues relating to the Board of Directors, etc.

Thank you very much. Well then, we will be having another meeting shortly so we can begin wrapping up. We do have a few matters that we have not been able to cover, and may need to sort them out as we do not have enough time with the current monthly frequency. Let's proceed in this direction then.

In closing, are there any communications from the secretariat?

[Mr. Tahara, Head of the Corporate Accounting and Disclosure Division] We will be setting the next date upon taking into account your opinions, and will get in touch with you shortly. Thank you very much.

[Ikeo, Chairman] Let us then proceed with an eye to wrapping the matter up. Thank you for making the time to attend today.