Opinion concerning the ideal state of the board of directors in listed companies

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In lieu of my attendance at the Fourth Follow-up Council Meeting of the Stewardship Code and Corporate Governance Code held on December 22, 2015, I submit my opinions on "the ideal state of the board of directors in listed companies," in particular the ideal state of "board resolution matters" and "CEO succession," as shown below. I would appreciate it if you could also refer to my work which is distributed separately for the details of my opinions expressed here.

No.1 General remarks: The core mission of the board is to monitor the execution side

・Under the Companies Act, there is a big difference in the function of the board between companies with *kansayaku* board on one hand and companies with three committees and companies with supervisory committee on the other. In the former, decision-making on important business operations are regarded as the exclusive right of the board while in the latter, with the exception of certain matters, it is generally accepted that the decision-making authority of the board is mainly delegated to the execution side. As a result, with regard to the question of "the ideal state of board resolution matters," under the organization structure of the latter two, institutional solutions have been planned to a certain extent. Therefore, **I express my opinion here on the ideal state of the board with companies with *kansayaku* board in mind**.

・There exist two opposing schools of thought on the issue of what the board should be like—the "management model" and the "monitoring model"—which is almost like a theological dispute. The management model emphasizes the aspect of the

board as the highest decision-making institution concerning business operations while the monitoring model emphasizes the aspect of the board as a supervisory institutional with respect to individual directors.

Under the law, the duties of the board are set out as deciding the execution of the operations of the company (Companies Act Article 362, paragraph 2, item 1), supervising the execution of duties by directors (same paragraph, item 2), and appointing and removing representative directors (same paragraph, item 3). Therefore, the boards in Japan are a hybrid of both models, but **in the majority of Japanese companies, the management model has been regarded as the mainstream. However, as I will elaborate further below, the actual situation is that out of the three duties stated above, the latter two are practically not functional, and as for the remaining duty of "deciding the execution of the operations of the company," in many cases, the board is operating on a "passive management model" that is merely a ratification body for "management meetings" on the execution side due to the high number of resolution items and the fact that the board is made up of "the president and his subordinates" through internal promotion.**

Following this, in this section No.1 of this opinion statement, I will express my view that the monitoring of the execution side should be regarded as the core mission of the board in listed companies considering that the management environment is undergoing drastic change nowadays. In section No.2, I will discuss what matters for board resolution should be like in order to let the board function effectively, and in section No.3, I will describe the ideal state for the succession of the CEO which is the issue of highest priority in monitoring.

・First, governance has an "growth-oriented" function (growth-oriented governance) for the purpose of achieving sustainable long-term growth of the company apart from the so-called "defensive" function (defensive governance), which is a corporate

governance mechanism that is part of a broadly defined compliance program for the purpose of preventing violations of the law by managers.

・Up till now in the majority of Japanese companies, a practice has been adopted in which members of the board assume the responsibility of executing business operations in the form of concurrent appointment as executive officers. In other words, boards based on the management model have been regarded as the general practice.

However, under this model, the board will be made up of the president and his subordinates. As it is difficult for the subordinates to put a stop to the reckless behavior of the president, this results in a system that is fraught with structural faults in the supervision function of the board. If that is the case, "defensive governance" will probably be expected of the *kansayaku*, but supervision of operations by the *kansayaku* is limited, in principle, to supervision of legality in the execution of operations by directors, and it is understood that this does not extend to the appropriateness in the execution of operations. **This leads to a situation in which "growth-oriented governance" cannot be achieved as in reality nobody can carry out effective supervision and inspection concerning the upside issue of improving corporate value**.

In addition, among boards of the management model, there are many cases in which consensus has become the principle in reality in combination with the Japanese corporate culture of communal solidarity among *salarymen*. **This results in a situation where decisions cannot be made until opinions are compared and adjusted to reach a consensus, and the speed of decision-making is slowed down. Since the business environment is currently undergoing drastic change due to increasing globalization and digitization, this lack of flexibility and slow speed in the decision-making process might be fatal**.

Furthermore, a reverse type of phenomenon is found at times where the actual decision-making is carried out by meeting bodies such as "management meetings" which are made up of practically the same members as the board, and the board becomes an unnecessary adornment. In other words, **an irrational situation has developed where the board is not serving any substantial function even though it calls itself the management model**.

・Even if we set aside the "passive management model" of typical Japanese companies that I described at the beginning, the concept of emphasizing to an excessive extent the management function of the board is not compatible with growth-oriented governance which responds as appropriate to drastic changes in the environment. **To achieve growth-oriented governance and defensive governance simultaneously, as I will elaborate further in section No.2, it would be desirable to remove as far as possible decision-making concerning the execution of business from matters that require board resolution, and to delegate authority to the execution side. In other words, monitoring of execution should be positioned as the core mission of the board**.

It must be added that, as I stated above, as long as decision-making on the execution of business is regarded as part of the duties of the board under the law, it is not my intention to suggest a complete denial of the management function of the board. However, we should consider the ratio of management to monitoring to be 2:8.

・As I stated at the beginning, unlike companies with *kansayaku* board, in companies with three committees, with the exception of certain important items, it is generally accepted that the board will delegate most of the decision-making on the execution of business to executive officers, and a governance system under the monitoring model is assumed to be in place.

However, even if a company adopts the organization of a company with three committees, it is clear from recent examples that careless operation will result in a scandal that has a significant social impact. I will elaborate on the details some other time, but I want to stress here that **even if a company were to blindly change its organization to a company with three committees, it does not imply that it will be able to build an effective governance system**.

No. 2 The ideal state of board resolutions—Necessity of "selection and abstraction"

・**In many listed companies in Japan, based on the modeling of the board under the management type, cases are found where a wide range of resolution items are put on the agenda of board meetings. One of the main reasons is the idea of "collective irresponsibility." The execution side including the president does not want to take legal/organizational risks concerning decision-making, so they try to spread out responsibility by submitting major decisions to the board for deliberation.**

However, as the matters to be resolved at board meetings cover an increasing wider range of issues, naturally, it is not possible for the board to devote themselves to an in-depth discussion of every single item. Speaking from my personal experience, **at least 20 minutes should be spent on each item on the agenda of board meetings**. But that is difficult considering the number of items submitted for deliberation and the length of time that board members are available for the meeting. As I mentioned above, there are many cases of "shan-shan (clap-for-approval) board meetings" where decisions have actually been made at another platform such as management meetings, and in actual fact only "reports" are submitted to the board even though they are presented as "matters to be decided."

To let the board function effectively, it would be desirable to remove as far as possible decision-making concerning the execution of business from matters that

require board resolution, and to delegate authority to the execution side based on the precondition that the core mission of the board is the monitoring of execution.

・With regard to this point, in companies with three committees and companies with supervisory committee, it is possible to transfer the majority of decision-making authority, with the exception of certain legal requirements, from the board to execution committees. In contrast, in companies with *kansayaku* board which make up the majority of listed companies, limitations in the transfer of authority is an extremely practical problem surrounding the interpretation of the text on "decisions on the execution of important operations," which is the right of the board (Companies Act Article 362, paragraph 4 introductory clause).

It goes without saying that what is considered "the execution of important operations" varies depending on the company, and it is probably not possible to introduce quantitative or formal criteria across the board. But a basic direction may take the form of the board carrying out discussions with the inclusion of independent directors on matters that have an impact on the long-term corporate value of companies and the execution side such as management meetings making decisions on short-term matters. Take for example matters involving the punishment of employees, apart from matters linked to scandals that shake the foundation of the company, submitting such matters for the consideration of the board is not the ideal shape that the board should take in the first place.

Furthermore, in the transfer of authority, even in cases where quantitative/formal criteria in the form of cash value are used, the qualitative perspective described above should also be adopted as supplementary criteria. For example, among M&A cases involving small sums of money, there are also important cases that have a big impact on the strategic direction of the relevant company. On the other hand, even if a M&A case involves a big sum of money, if it is an extension of something that has already been discussed in great detail at board meetings, then it may be

adequate to let such cases be decided at management meetings or at the discretion of the CEO.

No.3 The ideal state of CEO succession—Necessity for the substantial involvement of independent outsiders

・CEO succession (appointment and dismissal) is the highest ranking issue in corporate governance. However, there are many cases where this process is controlled by a mechanism of non-transparency personnel affairs called "OB governance," particularly in listed companies with a long history. This is a result of the fact that even the selection of the CEO is regarded as part of "internal promotion" due to the precondition of the board composition under the management model.

Given that corporate governance means to allow the authority mechanism of the organization to function healthily, corporate governance that is not involved in the personnel affairs of the top executives, which is positioned at the top of the list of functions, is no more than "playing a game of governance" in the final analysis.

・To conclude, if we are to try to secure transparency and objectivity in decisions on the appointment/dismissal of officers and remuneration which are the elements of monitoring and also in the procedure for the appointment/dismissal of top executives which is the centerpiece of governance, the development of a system in which these decisions are made mainly by committees with independent directors making up the majority is the inevitable conclusion we should reach in order to allow governance to function effectively.

However, this does not necessarily imply that one should change to a company with three committees. Although the nomination committee has the authority to determine the contents of proposals regarding the election and dismissal of directors

to be submitted to a shareholders meeting (Companies Act Article 404, paragraph 1; Article 416, paragraph 4, item 5 text within parenthesis), the appointment/dismissal of a CEO is conducted by the board (Article 416, paragraph 4, item 9 of the same law). , So it is not always true that the appointment/dismissal of the CEO is adequately exposed to the monitoring of independent directors just because one has adopted the structure of a company with three committees. As recent scandals have clearly shown, even if a company formally adopts the structure of a company with three committees, it may ultimately be used as a camouflage by the management side if operations are performed carelessly.

Even in a company with *kansayaku* board, it is possible to install a system that is equivalent to a nomination committee on an optional basis. Even if the system installed is actually an advisory committee that does not have any binding force on the decisions of the board, if it is clear that the said system stands in opposition to the board, it will serve as an opportunity to attract attention in the stock market. Furthermore, for example, if regulations are placed in the articles of incorporation that add on requirements for resolutions in the event that the board makes a different decision from the nomination committee, it may give further confirmation of the effectiveness of the said advisory committee in decision-making.

No. 4 Summary: Independent directors also need a suitable amount of readiness

・The ideal state of the board in listed companies described above is not something that can be achieved only with a reform in the consciousness of the people on the inside. **So long as the core mission of the board is positioned as the monitoring of execution, independent directors are the very people who will play a central role in governance.**

Therefore, **instead of merely voicing their opinions, independent directors are expected to take a proactive stance in situations when suitable subjects are not**

placed on the agenda by making proposals to the administrative division and getting involved in agenda setting. Independent directors must attend board meetings ready to take the last resort which is to exercise their authority to appoint or dismiss officers including those at the top.

・ Furthermore, I point out that too much emphasis is placed on the formal aspects in the criteria for selection of independent director candidates on the company side, in particular, the criteria for selection of people from financial institutions, and talented candidates get eliminated from the pool of independent director candidates. On the contrary, candidates whose independence is in doubt from a practical viewpoint end up getting appointed as independent outsiders.

To give an example of a method for solving this kind of problem, companies should adopt the practice of formulating a "safe harbor" by adding a more realistic perspective, such as whether the person who introduced a candidate has an interest with the candidate (e.g. whether it is an introduction from a financial institution that the candidate originally belonged to or whether it is an introduction by a third party whose objectivity/independence can be guaranteed) or the extent to which the company that is being introduced a candidate is dependent on doing business with the financial institution making the introduction.

・Given the timeline for decision-making of companies in general which hold their AGM in June, with regard to "the ideal state of the board" and "the ideal state of cross-shareholdings" which were discussed at the previous council meeting, it will be normal for companies to have decided on their policy for the next fiscal year to a certain extent around January or February.

And so, I would like to propose that we produce an "interim summary" of the discussion at this council meeting and make an announcement to the public early in

the New Year so that the content of the discussion here could be of some help to companies in their decision-making.