Minutes of the 4th Council of Experts Concerning the Corporate Governance Code

1. Time and date: 4:30–6:30 pm, October 20 (Monday), 2014
2. Place: Financial Services Agency

[Ikeo, chairman] Now it's already the scheduled opening time, so I'd like to open the fourth Council of Experts Concerning the Corporate Governance Code.

I was informed by Mr. Mori that he would be 5 minutes late. I assume Mr. Horie will be coming soon, although I haven't been informed. I'm pleased that all the members can attend today's meeting. I'd appreciate your cooperation.

I'd like to start the proceedings. Continued from the last session, we will go through the items described in the OECD Principles in this session as well. Specifically, as written on the cover sheet of Material 1, today we will be discussing Disclosure and Transparency, the Responsibilities of the Board (focusing on the fulfillment of their roles/functions, etc.), and Dialogue with Shareholders. Although the last topic is not an item covered in the OECD Principles, some members suggested at the last session that it should be considered for the purpose of the Japanese Code, we'd like to take it up for today's discussion.

First, the secretariat will explain these 3 topics, and then we will have discussions.

Now I hand it over to the secretariat for the overall explanation.

[Yufu] Let me explain the Material 1. The material is 18 pages long and divided into 3 items. I will explain the entire material without a break.

Please open the first page titled Disclosure and Transparency. Similarly to the material for the last session, provisions of the OECD Principles are listed in the left column in the same order as the Principles, and the corresponding items are described in the right column as examples of Points of Consideration.

Please look at the second bullet point on page 1. I'd like you to discuss how we should think about a clear explanation of company objectives. Following that question, I'd like to ask you what we should think about the establishment of a policy for determining remunerations for directors and senior managements, and disclosure of such information, as well as

disclosure of individual remuneration amounts.

Please turn to page 2. I'd like to have your comments on possible requirements that the board clearly articulates the basic approach, procedures, etc. concerning the selection of the representative director and other senior managements as well as nomination of directors and so on, and discloses such information, and also clearly explains reasons for selection/nomination of each individual upon submitting such a proposal to the general shareholder meeting.

Let me move on to the next bullet point, although I'm not going to explain Material 3. While companies disclose their basic approach to corporate governance under the current system, I'd like to have your comments on how we should think about each company disclosing its basic views/guildeline in accordance with the Code when this Code is established.

The next bullet points approach the topic from a slightly different angle. They are not about disclosure itself. The question is what can be considered, in order to ensure that external auditors - which means auditing firms and the like - properly fulfill their roles. On page 3, six points are raised as illustrative examples. I will skip explanations of each point.

The next bullet point is at of page 4. External auditors, or auditing firms and the like, are in a position to be elected by shareholders, although, of course, an audit contract itself is concluded by the management. What should we think about describing such a basic concept that the external auditors, therefore, "have responsibilities for the shareholders"?

Now please turn to page 5 titled the Responsibilities of the Board. Today we will focus on the fulfillment of their roles and functions. As written in the second line of the paragraph above the chart on page 5, as for such matters as institutional designs, structures, procedures or training concerning the board, we will discuss them in the next meetings. I'd expect today's discussion to focus on fundamental roles, functions, etc. of the Board.

On page 5, the question is what roles and responsibilities the board is basically expected to perform. As described in the parenthesis, such roles and responsibilities are not limited to the board's authority over specific matters stipulated in the Companies Act. Several specific examples are shown as bullet points. First, the board guides corporate strategy. Then, the board manages various types of conflicts of interests. Furthermore, the board assesses and oversees the management, considering managerial performance, and potential risks behind it. Then, the board selects and removes the representative director and other senior managements,

and incentivizes them to show healthy entrepreneurship, and conversely to avoid excessive risks.

Please turn to page 6. The board establishes or reinforces a compliance structure, instead of checking compliance of each individual business execution, and ensures a more proactive risk management system is in place. The next bullet point states that the board fulfills their fiduciary responsibility and accountability to the shareholders. As shown in the parenthesis, that includes helping senior managements to make adequate, and timely and decisive decisions, when such responsibilities are sufficiently fulfilled. The last bullet point refers to the cooperations with stakeholders.

This topic continues up to page 9. The upper-right column on page 7 shows an excerpt from the recommendation of the Liberal Democratic Party, which we referred to several times in this Council and three bullet points follow. The first bullet point calls for your comments on so-called separation of execution and oversight functions. The second bullet point: to ensure the board effectively fulfills its oversight function, what kind of balance is required for the board as a whole? On the following page 8, what should we think about the suggestion that the Code should include descriptions about *shikkoyakuin*, whose position is not legally stipulated, unlike *shikkoyaku* under the Companies Act?

Up to this point, very basic roles of the board are described. As for *kansayaku* and the *kansayaku* board, which have been discussed at this Council several times, they are to be covered when I explain page 13.

In the remaining part of page 8, I'd like to have your comments about stipulating directors' fiduciary responsibility in the Code. Please refer to the statement with an asterisk (*). It refers to the importance of their exercising influence over the management from an independent/objective standpoint, as the board has the fiduciary responsibility.

Please turn to page 9. From here, although there may be some overlaps with the earlier-mentioned points, specific points of consideration concerning the functions of the board are itemized. The first bullet point on page 9 is strategic guidance of the company. As for page 10, it would be better to look at the following statements with the asterisk (*). It may be related to the separation of execution and oversight, which I explained earlier: the board clearly defines and explains the scope of its own decision-making, and the scope of delegation to the management. The second asterisked statement is about the board' self-evaluation/analysis (*hyoka/bunseki*). This is a common practice in other countries. However, as far as the secretariat looked at the specifics of such practice, they are not

assigning a “rating (*hyotei*)” based on such a scale as A, B, C, D or E. Instead, for instance, they review the past year, and conclude that “the board had very constructive discussions in these areas, but its responses in those areas were weak.” Such an activity in other countries should rather be described as “*bunsek*i” (analysis) in the Japanese language. So while such an activity is called “evaluation” or “assessment” in English, we added the word “*bunseki*” (analysis) to “*hyoka*” (meaning evaluation, but it could be misunderstood as rating) to express it in Japanese. Then another question is what we should think about self-evaluation (analysis) of each director.

This topic continues on page 10. Again, please take a look at the asterisked sentence, which is a question about succession plans for the positions of CEO and other positions. What should we think about formulation and monitoring of such succession plans? With regard to the next bullet point, let me explain the asterisked statement. It is said that a fixed portion of officers’ remunerations in Japan is larger than that in other countries. In this regard, it is often pointed out that companies should increase a performance-linked portion of the remunerations, especially the portion linked to medium- to long-term performance. What should we think about it?

I would like to omit the explanation on page 12 as there is not much information in the right column of this page. In the upper part of page 13, what should we think about directors’ access to necessary information and support system in order to fulfill their responsibilities appropriately?

That’s all for the section of the board. Below the dotted line on page 13 is allocated for expected roles of *kansayaku* or the *kansayaku* board, which were discussed in earlier meetings as well. Under the second bullet point on page 13, it shows 3 examples, such as auditing business execution by directors. Needless to say, their roles are not limited to these examples.

There are 2 bullet points below that. Please look at the first bullet point. To what extent, should the *kansayaku* board be able to be involved in questions of ‘right or wrong’ beyond auditing the legality of operations? The next bullet point: while they have an obligation to attend the board meeting, they do not have voting rights. Given that, to what extent, should they be able to influence decision-making of the board?

The second and third bullet points of page 14 are about professional background, or knowledge and experience of *kansayaku*. Specifically, the third bullet point states that it is mentioned that the *kansayaku* board should include person(s) with knowledge of finance/accounting. What should we think about it? The next bullet point is about the support

system for *kansayaku* or the *kansayaku* board, as well as cooperation and information sharing with the management, internal audit department, outside directors, external auditors.

On page 15 and thereafter, points of consideration on Dialogue with Shareholders are described. Taking the previous discussion into account, the secretariat prepared a material for further discussion. In the left column, the codes of other countries are presented as a simple list. So hereafter, the right column does not directly correspond to the left column. Please focus on the right column for the discussion.

Page 15. After the establishment of the Stewardship Code, institutional investors are clearly requested to have dialogue with the investee companies under such code. What should investee companies consider the meaning of such dialogue to be?

In this regard, 6 points are raised as examples on pages 16-17. First, what should we think about improving the environment, for example, by clarifying who or which institution manages overall dialogue with shareholders and pays careful attention to realization of the constructive dialogue?

Then, when there is a request for face-to-face contact, – although it may depend on the shareholder's request – who would actually engage in each face-to-face contact and dialogue? Furthermore, we need to consider such points as ensuring internal cooperation, and providing feedback concerning opinions acquired through dialogue. At the upper of page 16: while the Stewardship Code is not written with the intention to restrict dialogue with institutional investors to face-to-face contacts, what should we think about investor briefings, IR activities, etc.? Page 17 handles announcement regarding the said policies and initiatives.

The following point on page 17 is based on the opinions in the previous session. Under the circumstances where beneficial owners of shares cannot be automatically identified, companies are undertaking investigations in many ways, and shareholders are also expected to cooperate with such companies' efforts to the greatest possible extent.

Finally, please turn to page 19. Page 19 is in the section of Dialogue with Shareholders, yet the left column shows the document approved by the Cabinet in June. Please take a look at the bottom four lines. It reads "[it is important] – primarily for global companies – to achieve sustainable increases in corporate value by giving consideration to the cost of capital and enhancing corporate governance." In response, the right column shows a bullet point: it is argued that in order to achieve sustainable growth, companies are required to develop business strategies and business plans, establish medium to long-term earnings plans and

capital policies, and set the target levels of profitabilities and capital efficiencies, and then clearly explain those matters to shareholders in an easy-to-understand way. What should we think about this point?

Due to time constraint, I'm not going to explain Material 2 and Material 3. Please refer to them as needed. That's all for my explanation.

[Ikeo, chairman] Thank you very much. Now I'd like to proceed to free discussion. Before that, let me make a brief announcement. Today as Mr. Toyama has to leave the session early, he presented his opinion paper, together with a reference material on Japan Association of Corporate Directors, as well as an opinion paper of the Japan Association of Corporate Executives, which were already distributed to you. The secretariat sent them to the members in advance, so I won't read them out here. I'd appreciate it if you would take them into account when you continue the discussion after Mr. Toyama leaves.

Well, let's start free discussion on a topic-by-topic basis. First, I'd like to have your opinions on Disclosure and Transparency. Who would like to start? Please go ahead.

[Mori, member] Thank you. In the last session, I told that I had a few topics I'd like to debate on when we discuss Disclosure and Transparency, so I'd like to make some comments.

Let me recap what I mentioned in the last meeting. There are 3 crucial questions: What kind of information will investors obtain prior to the exercise of their proxy voting rights?; What about the reliability of the information?; Do investors have sufficient time to examine the information? In light of the disclosure of accurate information, the reliability and quality of information is essential. And companies, which are responsible for the preparation of such information, have a great responsibility for the disclosure. The information to be disclosed undergoes audits by accounting auditors as well as by *kansayaku*, so that its reliability and quality are secured. To that end, it is necessary to secure a certain period of time.

In other words, unless companies can prepare a package of solid information before the dispatch of the convocation notice, the information would mean little. Companies' efforts for early finalization of their financial results have already been stretched to the limit. I believe it is undesirable to force companies to reduce time for preparing information for disclosure, aiming at the early dispatch of the convocation notice.

For example, by postponing the date of general shareholder meeting, we can assume that investors can secure sufficient time to comprehend information of their investee companies.

Furthermore, if the filing of the Annual Securities Report, which is the most detailed disclosed information at the moment takes place at almost the same time as the dispatch of the convening notice, investors will be able to prepare for the exercise of their proxy voting rights based on more information prior to the general shareholder meeting. Based on these premises, I believe it is desirable to secure necessary time between the date of the convocation notice and the date of general shareholder meeting.

Both financial statements under the Companies Act and the Annual Securities Report under the Financial Instruments and Exchange Act are regarded as the final reports of the companies. Although their purposes are different, in terms of results, there are many overlaps in the required information. Despite significant overlaps, there is a gap of 3 weeks between the dispatch of the convening notice accompanied by financial statements, etc. under the Companies Act and the filing of the Annual Securities Report. This difference in the timing of disclosure puts companies at disclosure risk, which means the different timing of disclosure requires companies to update the information, thus causing risk from updating.

For example, if subsequent events occur after the dispatch of the convening notice accompanied by with financial statements, etc., there will be a risk in how to deal with the disclosure in the Annual Securities Report. Besides, regarding audits by *kansayaku* on internal control, there may be cases where significant deficiencies which must be newly disclosed are found within the 3-week period. Currently, companies are exposed to risks due to the different timing of disclosure, in my opinion. I, therefore, believe it is desirable to disclose the financial statements, etc. and the Annual Securities Report almost at the same time.

As I mentioned in the last meeting, in the US and the UK, companies dispatch the convening notices after filing the Annual Reports. That means the Annual Reports are fully utilized for the purpose of exercising proxy voting rights at the general shareholder meetings. In Japan, the Annual Securities Report is generally filed in end-June, which is after the date of the general shareholder meeting. Therefore, disclosure in the Annual Securities Report cannot be utilized for the exercise of proxy voting rights. We should consider these points.

Furthermore, in response to Item C of Disclosure and Transparency section, several points are raised to ensure external accounting auditors properly fulfill their roles. While the OECD Principles do not clearly describe these points as the roles of external auditors, I believe they should be clearly written in the Japanese Corporate Governance Code.

In this regard, 6 points are written as examples. All these points are quite reasonable. Although I got an impression that they are slightly detailed to be included in the Code, I

understand the OECD Principles consist of the principles part and the annotations part. Many of these 6 points are written in laws or audit standards which are the standards for those who conduct audits. On the other hand, the Corporate Governance Code is the code for corporations and the management, so I think it is necessary that Code for the management should, in some way, include such important points to ensure the reliability of information.

May I continue?

[Ikeo, chairman] Yes, please go ahead.

[Mori, member] With regard to the board, and the *kansayaku* board…

[Ikeo, chairman] That topic will be covered later.

[Mori, member] Better to speak later?

[Ikeo, chairman] Yes, please.

[Mori, member] I see. I just made my points related to Disclosure and Transparency. Thank you.

[Ikeo, chairman] Thank you. Anybody else? Mr. Toyama, please go ahead.

[Toyama, member] Thank you. As I have to leave early, let me quickly share my opinions.

As written in my opinion paper handed out, my point relating to Disclosure and Transparency actually has some overlap with considerations of Dialogue with Shareholders, which will be discussed later. In the context of ensuring a so-called engagement in the future, financial information is certainly very important, but when the discussions on the companies' long-term strategies is actually the most significant information, I think it is crucial to disclose something like the so-called integrated report, which includes non-financial information. I hope this point will be included in our discussion. That's my first point.

Another point is the content of disclosure. The material explores remunerations and personnel matters. In my opinion, they should be taken as a matter of course. Such decisions should not be made in a manner without transparency. At the minimum, it is unthinkable for listed companies as public institutions to make key executive remunerations and personnel matter decisions behind closed doors. They should openly and squarely make appropriate

disclosures. In the case of Omron, even the particulars about how the President is nominated are made public as a part of its IR activities, so it shouldn't be a problem. This should be easy. I do believe we should include it as a matter of course.

I think I should finish here for now.

[Ikeo, chairman] As you are leaving early, you can make comments on the remaining topics, which we will discuss later, if you want.

[Toyama, member] May I? OK, I will try to make this short. Related to what I was saying before, I'd like to share my opinion about the responsibilities of the board, which is described on page 2 of my opinion paper. Some points of consideration are also raised on pages 5-6 of the material prepared by the Financial Services Agency. I would say "yes" to almost all the points of consideration raised. The board should basically focus more on oversight (*Kantoku*) when thinking about "oversight (*Kantoku*) vs execution." When I say "*Kantoku*", I basically want to express what we mean by "monitoring" in English. The word "*Kantoku*" might be slightly misleading in Japanese as the word itself suggests elements of execution. In short, what I mean by oversight is to induce better performance [from management]. Their job is to reprimand [management] for poor performance, as well as to acknowledge good performance and ensure further improvement. Involvement in meticulous execution of operations should not be the primary job, I think.

I'm moving on to page 3. Some people, however, argue that the above point is impossible under the Companies Act of Japan. It's all about how we interpret the Companies Act wording "execution of important operations". In fact, with the large corporations I'm involved with, the interpretation is polarized between the two extremes. Even between same-sized large companies, the number of matters for resolution differs significantly: whilst some companies have 3 or 4 at most per month, other companies have 20 to 30. The underlying fact is that the directors or someone else in that capacity has no guts – are afraid – and regard everything as important decision-making out of self-protection, so they submit too many proposals for resolution. Moreover, when they consult lawyers about such grey zone issues, the lawyers tend to take a cautious stance, and suggest to – although I don't think Mr. Takei will do so – and suggest that everything be resolved by the board. Quite honestly, such application of the Act is problematic. Under the current Companies Act, it should be possible to narrow down the number of matters for resolution to 3 or 4. To improve matters, I think the board could and should actually work in a manner to ensure the separation of execution and oversight to the maximum extent allowed by the Companies Act, if not more.

I'd like to make a brief comment on the *kansayaku* board, too. Regarding the *kansayaku* board, I do not have a negative view on the *kansayaku* system and I think it is a proper system on its own. However, because its importance is overemphasized, as shown on page 5 of my paper, to expand the job of *kansayaku* to the area of growth-oriented governance may cause a risk of breakdown of the system itself. Essentially, *kansayaku* is the core of 'defensive governance'. Therefore, I'd like them to fulfill their commitment to defense – this is my request from a practical viewpoint.

Let me tell you the reasons. I was involved in the investigation of the Kanebo scandal, probably the largest window-dressing case since World War II. As a result, the auditing firm involved was dissolved so the auditing firm did in effect take responsibility. My honest question at that time was what the *kansayaku* were doing. They had failed to find the window-dressing for a decade. This scandal resulted in the establishment of J-Sox, and I thought there would be no more scandals of this kind. However, surprisingly, the Olympus scandal and the Daio Paper scandal occurred after that. One common feature of these 3 scandals is that the root cause was top management – frankly speaking, criminal acts by the representative directors. Thorough examination should be performed to verify how the *kansayaku* system was functioning vis-à-vis such problems. If the system did not work sufficiently, it should be reinforced. This is a delicate subject, but let me tell you straight: in most of the established Japanese companies, including Kanebo, those who are promoted internally to the position of *kansayaku* are those who could not become directors. The position of *kansayaku* was given as a type of compensation to them, and the president has the authority over these personnel / appointment matters. At the same time, it is these full-time internal *kansayaku* who have access to a significant amount of information, which could serve as the basis of whistle-blowing. However, under such a structure, potential whistle-blowers who are willing to challenge the president would not be appointed as *kansayaku* and therefore I'm wondering if the system really works.

I have experience of serving as outside *kansayaku* and outside director. From my experience, there is a limit on the amount of information which an outside *kansayaku* can obtain. So I hope this Council will discuss this problem thoroughly.

Another point, I think we should not expect too much for the roles of *kansayaku* in the area of 'growth-oriented governance.' As written in my opinion paper, the core of 'growth-oriented governance' is the appointment and removal of top management: the ultimate power rests with those who have the authority to do so. Thus, without the authority to appoint/remove top management, it is meaningless no matter how vocal the *kansayaku* may become. *Kansayaku* can only be involved in such personnel issues in cases where the top

management commits a criminal act – in which case, I think they have rights to suspend the performance of duties or something to that effect. That means that *kansayaku* cannot remove top management unless top management commits a crime. We should not forget this boundary exists which the *kansayaku* cannot cross.

Now I'm moving on to the last topic, Dialogue with Shareholders. On the last page [of Material 1], it reads, "…in order to achieve sustainable growth, companies are required to … explain those matters … What should we think about this point?" I would put it the other way round. If they do not explain such matters clearly and logically, it is frankly not business management. If they cannot explain this, it is the same as them not doing anything. In my sense, or at least anyone thinking with a decent management sense, will think that providing such explanations is obvious and nothing special. Frankly speaking, if a company is managed by those who refuse to do so, it should not think about being a listed company. I believe in this point strongly to this extent.

As I'm leaving soon, I'd like to refer to the opinion papers from the Japan Association of Corporate Directors and the Japan Association of Corporate Executives. In my sense, both of these are organizations with members from top management. Therefore, I have a request for mass media. The media tend to easily write "the business community says so and so" straightaway. However, I'd like the media to read all opinion papers and accurately understand their positions before writing an article about the views of the business community. I'd like to stress that these opinion papers were prepared by a variety of members from decent companies. I believe that the papers were written taking into consideration the actual conditions of businesses in many ways. In that sense, I regard the OECD [Principles] as the floor, and these papers as the center of the strike zone in baseball. Not too high. This height.

From the very start, corporate governance was and is placed at the center of the government's Revitalization Strategy. If an effective Corporate Governance Code can be drafted easily from current practice, there was no need for the government to obtain Cabinet approval. Therefore, unless the Code moves on to a completely different level of corporate governance, it will not meet policy expectations at all. The Recommendations from the Japan Association of Corporate Executives and the Japan Association of Corporate Directors are aiming at the center of the strike zone. Personally, I think the pitch could be a little higher than that. I hope we will continue our discussion to create a totally different phase in the future. That's all I have to say.

[Ikeo, chairman] Thank you very much. We will take notes of Mr. Toyama's comments on the second and third topics, and go back to the discussion of the first topic, Disclosure and

Transparency.

Mr. Oguchi, please go ahead.

[Oguchi, member] Thank you. I read the section of Disclosure and Transparency [in Material 1] from the view point of investors. After all, investors are outsiders. For such general investors outside the companies, it is the prerequisite that the companies secure transparency of information on management, except for confidential information, through disclosure as a general rule. Although there was no explanation of Material 3 today, Fundamental Approach toward Corporate Governance on page 5 shows the analysis of keyword used by companies. Some 70% of the companies refer to the word "transparency." It implies there is a problem of information asymmetry related to governance. There is an information asymmetry between inside managers and outside investors, thus companies consider that transparency is essential. I think this is evidence.

Looking at the items related to Disclosure and Transparency in such a way, when we take 'comply or explain' approach, I think all items listed on the material should be included in the Code. I could not find any item to be excluded. I wondered what is wrong. The only slight reservation is the disclosure of individual remunerations on page 2. Such disclosure is becoming increasingly common in other countries. Yet in Japan, due to the resistance to disclosure, it may have a side effect: it may become an obstacle to the provision of appropriate incentives to top management and directors, as written later. It is not always right to disclose everything. The objective is to disclose appropriate information to general investors who are outsiders. From such a perspective, I have to put a question mark on the disclosure of figures of individual remunerations. This is my first point.

Another point – also from the viewpoint of investors – is about disseminating information as shown on page 4, Item E. To whom do companies disseminate information? Of course, to investors. Therefore, it will be meaningless, if the information does not reach investors and shareholders. Under the current circumstances where foreign investors account for 30%, they have a hard time understanding information in the Japanese language. So I think it is indispensable that such important information is disclosed in the English language as well.

That's all.

[Ikeo, chairman] Thank you. Does anyone want to make comments on this topic? Please go ahead.

[Mori, member] Allow me to make an additional comment. Item D on page 4 refers to external auditors, so I think I should make a comment from my standpoint [as an auditor]. An external auditor elected by shareholders certainly concludes an agreement with the company, and thus has an obligation of due care to the company. The fundamental role of external audit is to secure the reliability of information disclosed by the management, so it is related to who uses such information. Consequently, I would say that external auditors have responsibilities to the information users – not only shareholders, but also other stakeholders. So I think it is very meaningful to include such a basic concept in the Code.

As for the way to fulfill such responsibilities, currently, external auditors fulfill their responsibilities by issuing the auditor's report, which is summarized in a piece of A4-sized sheet. Furthermore, as they have an obligation to attend the general shareholder meeting and make an explanation there, they also fulfill their responsibilities on such an occasion. Now the Stewardship Code has been released, and investors express various opinions toward medium to long-term corporate value creation. Such auditors' responsibilities bear a part in information disclosure systems. Upon providing various types of information, users' opinions are being respected.

Let me introduce an overseas example, although it may take time until we see a similar trend in Japan. In these days, there is a discussion on making the auditor's report include not only the auditors' opinion, but also key audit matters, which are those matters that were of most significance in the audit. In the UK, it is becoming an actual practice. In Japan, what does the auditor's report need to include? I think it is an issue to be considered from now on. That's all from me.

[Ikeo, chairman] Thank you. Mr. Uchida.

[Uchida, member] First, as a basic approach to Disclosure and Transparency, I recognize it very important for sound corporate governance to make timely and appropriate disclosure and thereby secure the transparency of business management. It would be very meaningful to sufficiently explain to shareholders the company objectives, such as business principles, business policy, and business strategy, among others.

On the other hand, ingenuity is required to avoid the situation where unnecessary increase of disclosure impedes proper judgment of shareholders and investors, and poses a significant burden and cost to issuing companies. Companies already have statutory disclosure obligation under the Companies Act, the Financial Instruments and Exchange Act (FIEA), and Securities Listing Regulations. Thus, information to be disclosed should be selected upon thorough

consideration on the ground of what information contributes to a sustainable increase in corporate value, while maintaining the consistency with these laws and regulations.

I think the earlier-mentioned integrated report is also very important. However, considering that companies already issue various reports, such as Annual Report, CSR Report, and Intellectual Property Report, we should avoid adding an extra report. In my opinion, the crucial point here is to integrate what to show investors and what to show other stakeholders. I think it necessary to consider the matter from such a perspective.

Regarding remuneration disclosure, when the level of remunerations for directors of Japanese companies does not constitute an issue, we need to carefully consider whether disclosure of individual remunerations is really necessary beyond the current disclosure of directors' remunerations exceeding 100 million yen.

As for the earlier-mentioned disclosure in the English language, I understand that companies which have a large number of foreign investors or want to attract investment from overseas are actively promoting disclosure in English. At the same time I assume there are companies which have not received foreign investment. Therefore, we should not make it a uniform requirement. Instead, as written in the parenthesis on the material, it should be promoted "to a reasonable extent."

[Ikeo, chairman] Thank you very much.

Now may I move on to the next topic?

Next topic is the Responsibilities of the Board (focusing on the fulfillment of their roles/functions, etc.). How the board should perform its duties is one of the core issues. We will discuss the functional aspect first, and the organizational aspect in the next meeting. As "organization follows function," we should thoroughly discuss function first. Some people talk about organization without discussing function. As an economist, I don't think it makes sense. Today we will discuss how the board should be from the functional aspect, and hopefully achieve a consensus on what functions the board should fulfill. Now please share your opinions on this second topic. Mr. Matsui, would you like to speak first?

[Matsui, member] Sure. I'm sorry I cannot attend the Council on a regular basis. As described in the material, when the biggest goal of the Corporate Governance Code is also the long-term growth of the companies, I think the board should primarily determine long-term policies, and I don't want to impose an impediment on it. Certainly, [the board] should also

manage conflict of interests as well as risks. I serve as outside director for 3 companies. Realistically, even though I visit their sites as outside director, it is hard to understand details. Accordingly, if I'm required to deal with something I don't understand, I'll face a difficulty. They give me a prior explanation in a very careful manner. If I'm absent, they provide me with an additional explanation. Despite all that, I'm not in the know: I do not know inside details.

To tell you the conclusion first, all 3 companies deal with them [i.e. conflict of interests, risk management] at the management meetings. No exception. It's the same in our company. Therefore, I think the execution of operations should be done at the management meeting, where executive officers play a central role. Otherwise, it ends up hanging in the air. That's how I feel. I think the Code should clearly stipulate that the main role of the board is not the execution. Otherwise, it hardly works, I think. I generally support what is written in the material, but I think it would be better to sort out the matters from such a viewpoint.

[Ikeo, chairman] Thank you. Please go ahead, Mr. Horie.

[Horie, member] I'd like to share my opinion about the functions. The objective of this initiative is 'growth-oriented governance' – as called by Mr. Toyama, and it requires a function to influence the management somehow from the standpoint of shareholders, aiming at a long-term increase in capital productivity. Then what is needed to secure the effectiveness?

To influence the management for improving the capital productivity, a certain level of qualification is actually required. I hesitate to say this in front of a lawyer, but I'm wondering if lawyers or scholars can really fulfill such a qualification. Our objective is to consider 'offense' rather than 'defense'. Then the Code should refer to some sort of qualification of independent directors. That's my first point. Another point is related to what Mr. Matsui just said. Even if directors want to express their opinions to increase the capital productivity from the standpoint of shareholders, I'm afraid it would be difficult without sufficient information. I'm talking about the roles of independent directors as the standpoint of shareholders. Without sufficient information, they cannot play such a role, in my opinion.

One more point. If a company depends solely on its own internal logic, it cannot look at the capital productivity from different angles. I believe it is essential to incorporate a perspective of independent directors, who speak on behalf of shareholders.

These 3 points are what I wanted to share with you. Because I cannot attend the next

meeting, I'd like to make a comment about the composition of directors. The Japan Association of Corporate Directors, which Mr. Toyama belongs to, suggests at least one-third [of the board members should be independent directors]. I do think it is very important to include a requirement for at least 3 independent directors, or one-third of the members in terms of the proportion. I have no intention to stick to configuration requirements. Yet maybe top executives' attention is occupied by the market, employees and creditors, but they do not pay much attention to the shareholders. Given that, I'm not asking them to pay attention solely to shareholders, but I think a balance among stakeholders should be taken, to a certain extent. As the stakeholders could be categorized into 3 groups - employees, creditors, and shareholders, I'd like top executives to pay approx. one-third of their attention to shareholders. Therefore, I think the Code should stipulate a requirement regarding the number of independent directors – at least one-third of the directors and no less than 3 persons even in case the total number of directors is small. I repeat that I'm not sticking to configuration requirements. Yet to fulfill the earlier-mentioned function, and considering the current situation in Japan to some extent, I think we should set certain standards of configuration. I know this may be a point to be discussed in the next meeting, but I wanted to add this comment.

[Ikeo, chairman] Thank you. In the next meeting, we will discuss what kind of structure or system is needed in order [for the board] to effectively carry out required functions. As premises for that, we need to confirm what functions are required for the board through this discussion.

Does anybody want to make comments? Mr. Uchida, please go ahead.

[Uchida, member] I hesitate to repeat what everybody already knows, but I think we need to consider this issue by returning to the original point.

Basically in the US and Europe, the board is designed based on the monitoring model. The board is widely recognized as an institution to oversee and monitor the execution of operations. In Japan, on the contrary, the central role of the board under the "Company with *Kansayaku* Board" system is decision-making on the execution of operations. It's a so-called operation-oriented institution, whereas the monitoring role is assumed by both the *kansayaku* board and the board. I think these two institutional designs have been built upon different approaches, although they have the same objective - corporate governance – under the corporate laws. Behind these two distinct approaches, there are differences in social structures, especially labor market structures – presence vs. absence of liquidity in the labor markets. This would be the biggest causal factor.

Under the Companies Act [in Japan], there are three different company designs: "Company with Three Committees" which adopts the monitoring model; "Company with *Kansayaku* Board" which takes another [operation-oriented] approach; and "Company with Audit and Supervisory Committee" which lies somewhere between the former two types. Now that they are specified in the Companies Act, all three company designs are basically of equal value in terms of corporate governance. Accordingly, I believe it is absolutely necessary that the Code provides clear explanations of these three company designs with their respective features and stipulates all of them are of equal value.

Each company may take a different approach to the board, regarding whether it places emphasis on the monitoring or execution of operations. In the background of drafting this Code, it seems that forces toward the monitoring model come into play. However, when the companies reinforce corporate governance to increase their earning power, I don't think there is only one solution. The monitoring model does not fit for all: we cannot say it helps all companies to increase their earning power without exception. The ideal situation is where each company chooses an institutional design, which most contributes to the enhancement of its corporate value, at its own discretion. Suppose the established Code is biased toward the monitoring model, which places an emphasis on the separation of execution and oversight, under the circumstance where the majority of listed companies are "Company with Kansayaku Board". Such companies will face difficulties to apply the Code. This is an issue to be addressed in the discussion of the Companies Act.

"Company with Audit & Supervisory Board" system is not fully understood in other countries. In other words, the system is even regarded as problematic in terms of corporate governance. I believe it is crucial to clearly articulate the roles and responsibilities of the board and the *kansayaku* board, etc. as the bodies which play critical roles in corporate governance, in a manner aligned to the framework of the Companies Act, etc.

Especially, roles and authorities of the *kansayaku* board and individual the *kansayaku* board may not be fully understood by foreign investors. Thus it is essential to clearly articulate them.

As I mentioned at the second Council, although Mr. Toyama expressed an opposite opinion, I think the Code should not merely explain statutory rights and obligations of *kansayaku*. I believe it is important to describe a wider role to be played by *kansayaku*. *Kansayaku*, including outside members, are non-executive officers. In that sense, I think we could expect them to assume not only the function as a compliance officer but a wider role.

As their very strong authority over information gathering is guaranteed by the Companies Act, they are expected to make use of such information to provide opinions and advice, which contribute to enhancing corporate value. I think such descriptions of expected roles will not only deepen investors' understanding, but also facilitate better corporate initiatives.

I'm sorry for a long talk, but let me continue a little more. *Kansayaku* do not have proxy voting rights at the board, so some raise a question about the extent to which *kansayaku* can influence the decision-making of the board. I talked about the issue with various companies. In some companies, before they submit proposals to the board, they consult with the *kansayaku* board; and if any proposals are opposed, such proposals will not be submitted to the board. Accordingly, it would be practically difficult to make decisions on the matters opposed by *kansayaku*. I think judgments of the *kansayaku* board have significant influence on the board.

[Ikeo, chairman] Ms. Nakamura, please.

[Nakamura, member] First, listening to the discussion on the *kansayaku* board, personally, I'm not quite sure if there is a huge difference between Mr. Toyama's view and Mr. Uchida's view. Let me speak from my own experience. In our company, full-time *kansayaku* gather information; and if they find any problem, they share such a problem with outside *kansayaku* and outside directors so that these outside members comprehend internal conditions. In a practical sense, I think this model where full-time *kansayaku* always reside within the company and monitor the company – meaning the check by *kansayaku* is functioning － is working quite effectively. I also consider that this model can co-exist with the monitoring model.

I don't feel strange about the fundamental direction [i.e. roles and responsibilities of the board] written in the material. For example, I think it is a matter of course that directors have fiduciary responsibility, and directors should act in best interest of the company and the shareholders. However, the material also describes that directors are expected to "work with diverse stakeholders and considering their opinions". On its face, this may look like a contradiction to the following statement("directors should act in best interest of the company and the shareholders") Therefore, when we summarize the issue, we should reconsider and put a better phrasing such as "directors should act in best interest of the company and the shareholders". And I find that there are so many adopted foreign words written in katakana throughout the document. In order to ensure that the Code is widely understood and adopted by the listed companies, including small and medium-sized companies, I believe the final text of the Code should be written in plain Japanese so that everyone can understand it easily.

The next point is related to the subsequent part. There is a view to regard remunerations as an incentive. This is also related to the selection of directors, etc. I'm not sure whether this is a particular issue that is unique to Japanese companies, but incentives are not necessarily linked to money only in Japan: it is not always true that a higher remuneration motivates people to work harder. I think we should duly consider this point during our discussion. In addition, in retail industry like our company, no matter how hard the top management works, the companies cannot always achieve better business results. Rather, it is well-motivated employees who ultimately lead to better business results. Therefore, our discussion should not focus solely on incentives for top management. Instead, we should discuss what can be done to revitalize Japanese companies. That's all I have to say.

[Ikeo, chairman] Thank you. First, Mr. Oba, and then Mr. Oguchi.

[Oba, member] I'd like to share my opinion, focusing on the functions of the board. Looking at the current situation, as Mr. Horie mentioned earlier, the board is less conscious about shareholders compared to other stakeholders. We need to discuss on that premise. Otherwise, we will not be able to meet the objectives of this Council for drafting the Code. Therefore, I believe we need to recognize that how to satisfy shareholders' expectations is an essential function of the board.

In the meantime, looking at the current situation, I think we should be aware that its monitoring and risk management functions are relatively working well. Yet discussions toward sustainable growth may not be made sufficiently.

Accordingly, the roles of the board should be development of a vision toward sustainable growth, as well as discussions on specifically how to use management resources for the realization of the vision in order to satisfy shareholders' expectations. I think these are required to the board. That's all.

[Ikeo, chairman] Thank you very much. Mr. Oguchi, please to ahead.

[Oguchi, member] Thank you. I'd like to refer to the annotation of the OECD Principles. In the paragraph missing on page 5 [of Material 1], it reads that the OECD Principles "are intended to be sufficiently general to apply to whatever board structure is charged with the functions of governing the enterprise and monitoring management." The OECD member countries are diverse, and the systems and institutional designs vary from country to country. Given that, as Professor Ikeo mentioned earlier, we need to look at the functions first. When I

read the items listed on the material from the OECD's viewpoint – whether they are important functions of the board regardless whatever board structure is charged, I found all of them are quite convincing. Especially, Item E-1 on page 12 – which is to be discussed in the next meeting – provides good examples of the case where the board can exercise independent judgment to tasks where there is a potential for conflict of interest. It shows the examples of such tasks, namely, "ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and senior managements, and board remuneration." In other words, outsiders are often skeptical about such matters, even if there actually is no conflict of interests.

We've been discussing 'growth-oriented governance.' In order to be 'growth-oriented', it is crucial to inform outside shareholders how the company is operated in a manner to avoid conflict of interests.

Although it certainly is important to secure knowledgeable independent members to enhance diversity, the outside members do not know inside details, thus the inside members must make such a public appeal. I'd like to emphasize this point. When there is transparency, people do not criticize that personnel affairs, board nomination, and auditing are done in a self-serving way, and thus the management can boldly take risks in order to increase the corporate value. Although I think we will discuss the details in the next meeting, I read the opinion paper from the Japan Association of Corporate Executives, and found it informative: even "Company with *Kansayaku* board" and "Company with Audit and Supervisory Committee" could also establish nomination advisory committee and/or compensation advisory committee, of which the majority is independent directors. I know this is the topic of the next meeting, but I do believe the recommendation is worth reading.

I have talked with *kansayaku* several times, and understand how they feel, how hard they work, and how they contribute to the companies. However, from the viewpoint of outside shareholders, I think we should distinguish what can be done and responsibilities to be fulfilled. We often talk with companies, and I know their views. Yet, it is necessary to clarify who has authority and responsibility, for the sake of outside investors and shareholders to have dialogue with the company or exercise their proxy voting rights. We should discuss this point separately from the efforts by people in various positions. In that sense, - it seems Mr. Toyama has already left – as found in his paper for the previous council or elsewhere, upon the revision of the Companies Act, the Ordinance of the Ministry of Justice concerning outside directors is to stipulate that the presence of outside *kansayaku* does not provide any grounds to believe that it is not reasonable to have outside directors. I understand they concluded that outside *kansayaku* and outside directors have different functions. If their

functions are the same, there is no need that two boards exist. They are different, that's why they have significance. Then I think we should discuss what their different roles are.

From my experience of talking with companies, I'm aware that in-house *kansayaku* actually conduct deep on-site inspection and interact with various people within the company. I feel in-house *kansayaku* perform good functions which cannot be seen in other countries. Although our members pointed out earlier that foreigners do not understand *kansayaku* in Japan. Yet here is an interesting example. In October 2013, an organization named ACGA [Asian Corporate Governance Association], in which more than 100 foreign institutional investors participate, issued the paper titled "the Roles and Functions of *Kansayaku* Boards Compared to Audit Committees". I hope you had time to read it. The paper acknowledges advantages of the functions of full-time, in-house *kansayaku*, which cannot be seen in other countries, in the sense that they reside within the company and participate in deeper discussions. On the other hand, the paper refers to concerns over earlier-mentioned conflict of interests around *kansayaku*, compared to the Audit Committee in other countries. I think it would great if the Japanese Corporate Governance Code includes such points together with the discussion for improving transparency under 'growth-oriented governance' – incorporating options "A plus B", not "A or B". That's why I wanted to share my opinion with you.

[Ikeo, chairman] Thank you. Mr. Ota, please.

[Ota, member] Chairman Ikeo suggested that we should discuss functions first. I may have a little confusion between structures and functions. We've been discussing the responsibilities of the board, and I'd like to add my comment. I regret that I have to make this comment after Mr. Toyama has left, but I assume he will read the minutes later. Regarding page 5 of Material 1, as everyone knows, the current Companies Act stipulates the directors' obligation to oversee the execution of duties as well as decision-making of the execution of operations.

The members have presented proposals for improving the Japanese-style board. Of course, I won't say that there are no problems, but as far as I know, there is no empirical study which proved the monitoring model of the board is superior as an institution.

Therefore, a more important question here is what functions the board is primarily expected to perform. I think the most crucial role would be the strategic guidance of the company, as written on page 5. Nonetheless, I'm not comfortable with concluding that other functions are also its primary roles. I'm talking about such roles as managing conflict of interests, assessing the management in various ways, and so on. Especially, I'm concerned

about appointment/dismissal of senior managements or evaluation of top management. Each company could prioritize the board's roles and responsibilities in the list depending on their actual conditions. I have to repeat this: In Japan, the evaluation of top management or appointment/dismissal of senior managements are not necessarily viewed as the primary functions of the board.

And when we discuss the composition of the board, I do think it is essential to ensure diversity among the members, of course. As I mentioned in the last meeting, needless to say, expert skills and work experience, or insight and knowledge of the company are required. In addition, it is dispensable that people within the company who have operational experience and the corporate activities join the discussion of the board. I'd like to point out this issue.

This might be about the structures. Among the institutional designs for corporate governance involving the board, I'd like to repeat that 98% of the Japanese companies have adopted *kansayaku* system. We should be aware of the fact. Although the relevant evaluation should be made some other time, some companies continuously undergo various trials. For example, in Toray Industries – which Mr. Uchida belong to – and many other companies which adopted "Company with *Kansayaku* Board" system, they have established optional nomination advisory committee (to nominate president) or compensation advisory committee under the board, where an outside director assumes the role of chairperson. It could be said a hybrid institutional design. I would say the number of the companies using this model is not negligible. I would naturally expect some argue that such committees are optional, and thus not enforceable. Yet the fact that an outside member assumes the role of the chairperson secures independence of the committee as an advisory body, and the board respect its recommendations: I think such operational practice is increasingly entrenched in Japan.

May I continue?

[Ikeo, chairman] Sure.

[Ota, member] From page 13, the roles and responsibilities of *kansayaku* are described. Many points of consideration are listed up. I wondered how I should answer the second question from the bottom of page 14: to what extent should they be involved in questions of 'right or wrong' beyond questions of legality? As you already know, regarding the scope of business audits performed by *kansayaku*, there still is an argument whether it should be limited to the legality, or extended to appropriateness and reasonableness. Nevertheless, I'm telling you how *kansayaku* are actually working. They make steady efforts to build up operational practice. As for the substance of work, to tell you the conclusion first, I

understand it is not necessarily limited to legality audits.

Considering our daily activities – I mean what *kansayaku* are doing every day, for instance, upon conducting business audits, we do not care whether we are auditing the legality, or making judgment of appropriateness and reasonableness. Rather, we believe it would be better for the companies, and ultimately for the investors and other stakeholders, if we presented our findings and expressed our opinions based on various operational experiences. That's our reality. You can criticize such reality in many ways, but this is the reality.

To be specific, let me share with you some data from the survey, which our organization [the Japan Audit & Supervisory Board Members Association (JASBA)] conducted in 2012. Even if not asked by the chairperson, 87% of *kansayaku* - both in-house and outside members - express their opinions. Their opinions can be classified into 3 categories.

The first category is matters concerning risks of business management, risk management, or the extent of damage. Although the survey allowed multiple answers, 87% of the respondents replied that they express their opinions in this category. The second category is matters about compliance with laws and regulations as well as the Articles of Incorporation, which accounted for 82%. The third category is questions about whether the principles of business judgment are sufficiently observed, which accounted for 61%. This is our survey results.

My point is that I'd like concerned parties to understand that auditing practices which can be described as auditing of management efficiency are in place, and they are best practices which were already adopted in many companies. While the *kansayaku*system was developed only in Japan, I think it necessary to positively perceive the achievements and distinct features of the *kansayaku* system.

Furthermore, there is a viewpoint on such issues as expertise of *kansayaku* as well as their qualifications for individual engagements. The Japan Audit & Supervisory Board Members Association (JASBA) has already established the Code of Kansayaku Audit Standards. The Standards stipulate that it is desirable that [at least one] *kansayaku* has adequate knowledge of financial and accounting matters. In the meantime, I think knowledge of financial and accounting matters is not necessarily a mandatory requirement for *kansayaku*. Especially, in case of "Company with Audit & Supervisory Board", those who are appointed from within the company as *kansayaku* have various experiences in the company's operations. When the board consists of multiple *kansayaku*, I think it is desirable to be a group of people who have various operational experiences, and their expertise do not have to be restricted to knowledge

of laws and accounting matters.

Nevertheless, to conduct audits more efficiently, I'm aware that knowledge of the Companies Act, FIEA, etc. is naturally required. So, for example, when we explain the *kansayaku* system of Japan, they could disclose their experience of receiving training courses offered by JASBA.

Specifically, according to the 2012 data, which is limited to those of the companies listing on TSE 1st section, approx. 70% of the companies state on their Annual Securities Reports that they have *kansayaku* with adequate knowledge of financial and accounting matters.

On the other hand, JASBA offers approx. 60 finance and accounting training sessions per year, and the number of the participants is more than 12,000 persons. That means approx. 200 *kansayaku* participate in one session. Some do not have much knowledge in question, and some do have knowledge but receive the training for the review purpose. There is such actual data. Actually, *kansayaku* are willing to receive this kind of training, and JASBA offers such training opportunities. So I think we could add such training experience as a matter subject to disclosure.

Let me make another point. It is about outside directors and *kansayaku*. As Mr. Uchida discussed earlier, they are the same in terms of the status being non-executive officers. However, outside directors are not assumed to serve full-time. Accordingly, there is a limitation to the volume of information they can get. This would be a disadvantage. I think the Corporate Governance Code needs to stipulate that effectiveness of corporate governance in Japan will be significantly improved through the cooperation between such outside directors and *kansayaku*, by allocating an independent section to this issue. Sorry for my long talk.

[Ikeo, chairman] Thank you very much. Mr. Kanda, please go first.

[Kanda, member] Thank you. I'd like to make three points. Mr. Toyama's expressions – 'defense' and 'growth-oriented' – are easy to understand, so I'll borrow these terms. Among the functions of the board listed on pages 5 to 6 of Material 1, I assume that managing conflicts of interest and ensuring compliance fall under the category of 'defense'. Rather, for now, I'd like to look at the 'growth-oriented' side.

From this viewpoint, regarding the functions of the board, as pointed out earlier, the board of directors can be classified into 3 categories. The first one could be called as "the monitoring board" where the function of the board is monitoring. This is increasingly

becoming popular in the US and Europe. ‘Monitoring’ here is not defensive one, and is also referred to as “oversight”. We should not misunderstand this point. The second one is, I would say, the management board, whose main function is decision-making on the company's operations. It is pointed out that the boards of many Japanese companies are in this category. The third one performs both functions, which I would call the hybrid board. After all, all of these three boards are possible options, so it is difficult to what is the best. Also in the US and Europe, in my understanding, all boards of directors of listed companies used to be the management boards. It was pointed out in US literature.

Then why were the management boards of listed companies replaced by the monitoring boards in the US? I think a further study is required on this point, because it will be useful when we discuss whether and how the board’s functions should change in Japan in the future, from the perspective of economic growth.

As far as I know, there are different views on the reasons why the management board was replaced by the monitoring board in the US. There is thus no single dominant reason. However, speaking of the common understanding, I would say the biggest reason was “the eyes of stock markets”. Due to the time constraint, I’ll try to make it short – when we incorporate “the eyes of stock markets” or the stock market perspective into discussion, including this council, should the functions of the board change in Japan, and if so how? There should be multiple paths. I’m wondering whether and how we should describe this point in the Code.

The second point. Strictly speaking, it may not be the function of the board, but when I think of the situations where proposals for the election of directors or remunerations are submitted for discussion and voting at the general shareholder meeting, from the perspective of investors in stock markets, investors would want someone to express views on such proposals. I feel we need to have in place such a function that outside directors or someone in a similar capacity express their views on behalf of shareholders on the proposals for election, or remunerations, if any, submitted to the general shareholder meeting. It may not be a function of the board itself, but I think such a function should be performed by someone.

It is desirable that those who express their views should be those who assume responsibilities for shareholders. So although I said “outside directors or someone in a similar capacity” earlier, I would rephrase it in accordance with the current Companies Act: those who owe the duty of care should be desirable for the function.

The third point. This may not be a direct function of the board, either. Having listened to

various opinions today, I feel it is also important for Japanese companies to take risks, and they need to take more risks, although it is written on page 5 [of Material 1] as "(including) the avoidance of excessive risks" in a parenthesis. I think what is written outside of the parenthesis would be more important in this context. Therefore, according to the statement outside of the parenthesis, it might be better to describe as "to exercise healthy entrepreneurship." Such risk-taking, however, may result in negative consequences. It is thus required to establish a mechanism or rules which protect directors from being liable for such negative consequences. This is extremely important. Otherwise, they would take a conservative approach without taking risks: that would not be desirable from the viewpoint of growth-oriented corporate governance. Therefore, I suggest that we discuss a mechanism or something enabling directors to take more risks without being liable for consequences.

[Ikeo, chairman] Thank you. Mr. Mori.

[Mori, member] There may be some overlaps, but I'd like to express my opinion anyway. This Council was established for drafting the Corporate Governance Code, which is expected to work together with the Stewardship Code, which was already published, as two wheels of a cart to drive the corporate growth. Thus, the perspectives of shareholders and investors would be extremely important. In this circumstance, I think it is necessary to explain how the monitoring function and management function are distinctively defined first.

In case of Japan, there are 3 types of listed companies, namely, "Company with Three Committees", "Company with *Kansayaku* Board", and newly introduced "Company with Audit & Supervisory Committee". Depending on the structures, the monitoring function and management function may vary. I think the companies need to explain that point first. Therefore, in case of "Company with *Kansayaku* Board", if the management function is to be performed by the board, the companies need to explain the mechanism to make the monitoring function sufficiently performed by the *kansayaku* board. Or alternatively, if the board assumes the monitoring function, the companies should explain how the companies are managed. Even if it is not included in the institutional designs stipulated by the Companies Act, I think each company could explain its institutional design.

Furthermore, in "Company with *Kansayaku* Board", the kansayaku board bears an important responsibility for the monitoring. The point at the bottom of page 14 refers to "the structure necessary [for the *kansayaku* board] to effectively fulfill their responsibilities." This is very important, and I think the Code should include a statement to secure such a structure(s).

It is also crucial for the *kansayaku* board to work or cooperate with outside directors or external auditors to perform the monitoring. Besides, I think it is necessary to have a mechanism to ensure interactive communications, instead of one-way reporting.

Above this item, it is written that the *kansayaku* board should include a person who has knowledge of finance and accounting matters. The *kansayaku* board as a whole needs to include a member(s) with knowledge of financial and accounting matters. The same could be said regarding outside directors who perform the monitoring function. As for the management [function], for instance, if the companies place importance on corporate management strategies or M&A from a managerial perspective, naturally, such experts should be included in the board. It is also required to define and present such qualifications from the viewpoint of monitoring. And, the *kansayaku* board is required to assess the suitability of accounting auditors. As it significantly affects the quality of disclosure, it is a very important function. To assess the suitability, I consider the detailed knowledge of accounting auditors' audits is indispensable. As for the statement "*kansayaku* (and/or *kansayaku* board) should include a person(s) with knowledge of finance/accounting," it does not mean all the members must have such knowledge. I think it would be sufficient if the *kansayaku* board a whole had such a function and knowledge. That's all.

[Ikeo, chairman] Thank you very much.

I'm a facilitator, and it may not be appropriate to express my own opinion, but I think what two members just mentioned is an essential point. For instance, "Company with *Kansayaku* Board" is recognized by the Japanese law, and thus an adequate and legitimate system. However, it does not mean that directors of "Company with *Kansayaku* Board" may perform only the managing board's functions. They still need to perform the monitoring function at least at the level equivalent to that of "Company with Three Committees". Conversely, directors of "Company with Three Committees" should perform the managing function at either equal or surpassing level. Therefore, the functions are not defined by the company structures. I presume it is necessary to modify the organizations within each company system, in order to perform required functions.

Now I turn it over to Mr. Takei first, and then Mr. Callon.

[Takei, member] Thank you. I was going to make exactly the same point as what Chairman just said. Let me add some comments. As for the functions of the board stipulated in the OECD Principles - 8 items such as guiding corporate strategy, and guiding medium to long-term direction, these functions need to be performed within the company, putting aside

the question of exactly which body performs, I think. Regardless whether it is called monitoring or something else, certain organization within the company must do it. Regardless of company types – whether they are Companies with *Kansayaku* Board, Companies with Audit & Supervisory Committee, or Companies with Three Committees - all companies must sufficiently consider and set up these matters (items) within an internal body.

In case of "Company with *Kansayaku* Board" in Japan, the board concurrently makes various decisions on execution of operations. Some companies cope well with it. Yet in many listed companies, the board has not sufficiently discussed the medium to long-term direction of the company. The mere fact that the Code refers to such an issue would have some effect on the current situation. No matter which institutional design a company adopts, the Code should clearly states that these functions required by the OECD should be fulfilled by the board.

In this connection, I would say the term "monitoring model" is an ambiguous term with multiple definitions depending on speakers. We should not, therefore, argue over whether or not a company has adopted the monitoring model. Some extreme arguments say that the monitoring model is the system where the decisions are made by the outside independent members. Which part of the western management mechanism speakers refer to by the term "monitoring model" vary unexpectedly. Reference to such term would lead potentially misleading result, which is simply inefficient. Instead, I think we should basically make an explanation by specifying which body or organization fulfills the functions required by the OECD. This is my first point.

My second point has some overlaps with what Professor Kanda mentioned earlier, especially what he mentioned about the environment allowing for risk-taking as well as non-liability to outcomes. Page 5 to 6 refers to "To exercise healthy entrepreneurship" and "helping senior managements to make adequate, and timely and decisive decisions". This point is very important under the current Japanese situation, since it shows 'growth-oriented' or 'value-creative' business management as mentioned in Mr. Toyama's expression, as opposed to 'value-protective' management, and it allows senior executives to take on challenges. So please state about the value-creative management in the context of the mechanism of corporate governance.

In relation, the major problems in Japan include the lack of indemnification, and the insurance coverage. In this regard, I'd like to request that the Code clearly stipulates that the board should create an environment which allows senior executives to take on challenges.

The UK Code stipulated that the companies should take out insurance with an appropriate coverage. The OECD Principles also states that the duty of care does not extend to errors of business judgment so long as board members are not grossly negligent, meaning liability should not be imposed on the board members. In Japan, such an approach is not yet in place. In the US, although the similar code does not exist, most companies have indemnification provisions in their by-laws. As there are no such laws or by-laws in Japan, the board should discuss thoroughly about the development of the environment which allows the management board to take on challenges.

Because this indemnification or insurance may involve some conflict of interests, it would be appropriate that the supervisory board is involved in the arrangement. Therefore, it should be written in the Code as the matter to be done by the board. This is my second point.

My third point is related with the second point. Partly in response to the Code, the functions of the supervisory board will be more organized and rationalized, and the board will monitor the execution of operations more effectively, and thereby executive directors can demonstrate, when their business judgment is legally challenged in case of such as shareholders' lawsuit, that they are fulfilling the duty of due care. I'd like to request that the Code expansively describes that it provides such a legal basis. It could be said to be the corporate governance system to support growth-oriented or value-creative management. When the supervisory board duly fulfills its supervisory function, the very fact has a positive effect to establish the environment which allows for taking on various challenges. I'd like to request that the Code include a statement to this effect. This is my third point.

The fourth point is related to nomination and remuneration. I believe that in every country, decisions on nomination and remuneration are made with the involvement of board members who do not have any conflict of interests. And I know the procedural issues such as "what kind of committees should be organized?" would be a major concern. Yet, before discussing it, it would be better if the Code provided some examples of factors to be considered: specifically, what factors should be taken into consideration to make decisions on nomination or remunerations?

For instance, with regard to the nomination, one of such important factors is diversity. Yet on what ground does a company decided to ensure this kind of diversity? Regarding the composition of the board, trade-offs always exist: in-house members are familiar with corporate affairs and information, while outside members ensure independence but do not have sufficient knowledge of such corporate affairs. There are various factors to be considered. Then in the decision-making process, which factors were considered? How did they judge that

candidates in question are suitable for the board members to express whose interests? The issue over the member composition should be thoroughly discussed by the board. In many Japanese companies, the boards have not yet sufficiently discussed this issue. I think the Code should bring about a fundamental change concerning in this regard. Accordingly, the Code should not provide a straightforward conclusion on how the composition should be, but rather show illustrative examples of the factors to be considered when companies make decisions on the board members. This is my opinion concerning nomination.

I'm moving on to remunerations. I believe that Japanese companies should more widely adopt the remuneration linked with medium to long-term performance more. Both in the OECD Principles and the codes of other countries, it is stipulated that the most fundamental factor to be considered in making decisions on directors' remunerations is whether such remunerations serve as an incentive to enhance medium to long-term corporate value. Thus the Code should clearly articulate that whether remunerations are determined for the objective of enhancing medium to long-term corporate value is the essential factor to be considered. Another factor to be considered is what kind of benchmarks should be used for measuring long-term performance-linked remunerations. Also it should be considered whether the remunerations contribute to a sense of solidarity or balance within the company, as Ms. Nakamura mentioned earlier. There should be at least 5 or 6 factors to be considered. I'd like to request that the Code provides such examples.

Taking such factors into account, through what procedures decisions are to be made? This question leads to another question on process issue such as whether or not the companies set up the nomination advisory committee or compensation advisory committee. Before going into process issue, the Code should first summarize what should be considered, and then describe how the nomination and remunerations should be.

Next is my fifth point. In connection with the remunerations, I think there is some misunderstanding about stock ownership of non-executive officers, including outside directors. In various countries, the codes clearly state that the management and supervisory board members should have ownership in the company. Actually, there are quite a few codes which stipulate they should hold a significant portion or significant number of stocks of the company. In Japan, the stock ownership of the board members is not yet at that level. But regarding a certain number of stocks held, I think the companies should have internal discussions on to what extent the management board and/or the supervisory board members should have stock ownership and disclose the relevant information. The conclusion on the extent of the stock ownership of the board members may be made by each company. The Code should, however, stipulate that the companies should discuss such the stock ownership

of the board members.

In addition, concerning non-executive officers' remunerations in the form of stock ownership, the term "stock option" is understood in many different ways, and there is confusion in discussions in Japan. In the US and Europe, pure stock options which are linked to stock prices, or performance shares where the number of shares changes depending on the performance are considered inappropriate as remunerations for non-executive officers. Yet it does not mean that non-executive officers are prohibited to have stock ownership. On the contrary, many countries encourage stockownership. I think this point is misunderstood in Japan. I'd like the companies to discuss and disclose the alignment with interests of shareholders, including non-executive officers, and the said equity remunerations. This is my fifth point.

Finally, my sixth point is about the system to support non-executive officers, as described on page 13. The Companies Act also addresses this issue in many ways, but there still are a number of shortfalls in the system to support non-executive officers in Japan. Let me talk about human, physical and financial resources separately. Regarding human resources, there are still many companies which do not assign anyone to assist or work under non-executive officers. It should be necessary to secure personnel to support non-executive officers. Furthermore, the companies should define how to decide the rotation of staff members to support non-executive officers, how to evaluate such staff members, and the mechanism to motivate such staff members.

Regarding financial resources, according to the provisions of the Companies Act, the companies are required to provide funding necessary for non-executive officers to perform their duties. However, there are many examples of non-compliance. For instance, some companies fix their annual budgets, and non-executive officers are not allowed to spend money exceeding the budgets – they do not provide against emergencies. To avoid such a situation, the budgets should not be decided solely by the management board. Instead, the supervisory board should be involved in such decision-making process.

These are all I wanted to say.

[Ikeo, chairman] Thank you for your great contribution. Mr. Callon, please go ahead.

[Callon, member] Thank you. Before discussing the role of boards of directors, I think we need to consider the role of listed companies more broadly. Mr. Takei expressed it with great clarity, and I agree with his view. A listed company is an institution whose purpose is to grow

corporate value over the long term. Companies' social value is to provide high-quality goods and services for customers, create meaningful employment for employees, and contribute to local communities and society at large. In short, running a listed company well is a meaningful social activity. And it is the board which drives and supports companies' growth in corporate value.

The question that faces this Council in drafting Japan's corporate governance code is whether we should maintain the status quo, slightly modify the status quo, or pursue large-scale reform. I understand that the objective of the corporate governance code is to support the government's Japan Revitalization Strategy, not merely status quo maintenance, and the Council's fundamental premise is the necessity of reform. There is a clear consenus that while growing long-term corporate value is the role of the listed companies, unfortunately Japanese companies have not succeeded in this goal. Compared to all other advanced industrialized economies over the past few decades, Japan has been the poorest performer in terms of growing corporate value. Indeed, regrettably there has been a significant loss of corporate value in Japan. As for ROE, the return on capital entrusted by shareholders to companies, Japanese companies have generated the lowest returns over time and Japan has also had the lowest stock market returns over time. In my opinion, this is not representative of Japan's excellence. We need to do better.

Therefore, in seeking to serve the interests of Japan and the Japanese people, I would suggest that the status quo is not acceptable, and that this Council needs to endorse and enact radical positive reforms. In particular, from the viewpoint of shareholders it is not acceptable to maintain the status quo.

By the way, I serve as the executive chairman of a listed Japanese company and chair the annual general shareholder meeting. We have approximately 40,000 shareholders, and as far as I can tell from meeting them at our general shareholder meetings, most of them are elderly. The senior generations that have preceded us are entrusting the funds they have saved over many years to the current management of companies, and management has the responsibility to respond to the trust that shareholders have shown in us. With respect to this requirement, the outcomes that we are currently generating are not satisfactory.

In this regard, the distinctive feature of Japanese corporate governance is not institutional design, but outcomes. If outcomes are insufficient, companies need evolve institutional design to generate better outcomes. I would be grateful if you could please take this point into consideration.

[Ikeo, chairman] Thank you very much. I assume nobody denies the significance of the role to guide corporate strategy toward the sustainable economic growth, or the significance of the monitoring function in the original sense of the term. I think we reached consensus that especially in Japan at the moment, it is required to reinforce such functions as an essential task. In the next meeting, we will discuss the organizational structures – for instance, the necessity to have a reasonable number of independent directors – in order to have these functions in place.

Time is running out. Does anyone want to share any comments regarding the final topic, Dialogue with Shareholders? Professor Kanda, please.

[Kanda, member] Before expressing my opinion on Dialogue with Shareholders, I'd like to clarify my position first: I support the Japan's Stewardship Code and dialogue with shareholders, which are great. Having said that, I'd like to raise a caution.

Although it is great to have dialogue with shareholders, companies should be careful about not having too much dialogue. As Mr. Oguchi mentioned earlier, institutional investors and other shareholders are basically "outsiders" in Mr. Oguchi's expression. Although they hold stocks for a medium to long term, they are basically investors who sell and purchase stocks. Accordingly, from the perspective of investors in stock markets, it is not desirable for them to become stable shareholders as a result of too much dialogue. Specifically, I'd like to refer to 3 points.

First, I think the Code should not describe this topic in a way that it focuses solely on the dialogue with investors who are subject to the Stewardship Code – I would call them as institutional investors in a broad sense. We should ensure that both institutional investors and other general shareholders are treated equally. In fact, as far as we look at the codes of other countries quoted in the left column, they describe it as dialogue with "shareholders" not "institutional investors." We should consider dialogue with shareholders, although I'm aware that specific situations should vary from company to company.

The second point. I just double-checked, and confirmed that this is stipulated in the Stewardship Code. Too much dialogue may result in obtaining inside information or other non-public information of the company. Such a situation is not preferable for institutional investors, and is in conflict with the interest of general shareholders as investors. This point requires careful attention, as stated in the Stewardship Code. I wanted to mention it.

My third point may not be directly related to dialogue, and is thus not written in the

Stewardship Code. So I just bring up an issue. If a takeover bid (TOB) - typically a hostile bid - is made for a company, especially where such TOB is made at a price significantly higher than the current market price, the Stewardship Code does not say anything about whether institutional investors should accept the bid. I understand the Stewardship Code keeps silent on this issue. The Corporate Governance Code is the code for companies. Although there may be some exceptions, in general terms, it should be considered that companies should not, in principle, prevent shareholders from selling their shares or accepting the bid. This may not be a subject suitable for the codes for institutional investors, or may not be covered by such codes because a consensus is not reached. Yet I think we should consider whether we can and should mention it in the Code for companies.

[Ikeo, chairman] Please go ahead.

[Horie, member] Thank you very much for including Dialogue with Shareholders in our discussion. As Professor Kanda just pointed out, I was a member of the council for the Stewardship Code, and heard there are some adverse effects from the implementation of the Stewardship Code. For example, some industrial companies complain that they now receive too many formal, superficial questions from those who do not consider medium to long-term corporate value as well as requests for meetings, when they are extremely busy. Such requests seem to be made just to achieve the target number of meetings held, using the Stewardship Code as an excuse. Such situations significantly diverge from the intention of the Stewardship Code, which encourage constructive dialogue focusing on corporate value. Nonetheless, such situations are arising in some places. Here is another story from the opposite side. Two weeks ago, I explained the current situation of the Corporate Governance Code to a long-term investor in New York. Although I cannot tell you the name, I was asked for advice by a very large company. “Our CFO cannot tell the difference between cash flows and financial strategy. Mr. Horie, please help us.” They pointed out that the management does not understand very primitive matters. Where does such a recognition gap between investors and the management stem from? I think it was because disclosure is not sufficient for dialogue with shareholders.

I understand that top management wants to explain their long-term vision of business or their stance, but I’m afraid they cannot make discussion when they just have a rough idea. They need to show specific targets and the related information: for instance, they could set the target figure or range of the capital productivity in the medium-term business plan, and Key Performance Indicators (KPI) to achieve the target. For instance, through ordinary DuPont analysis, they can set the rough target figures of profit margin, asset turnover, and leverage (equity multiplier leverage). And they could tell what they are considering to achieve such targets. Sorry for the very primitive comment. Anyway, I’d like industrial companies to

disclose such fundamental information to facilitate dialogue. If such disclosure is made, investors will not ask primitive questions concerning “low ROE” as I mentioned earlier, and more constructive dialogue can be facilitated. I assume that the minimum requirements for disclosure for the purpose of promoting constructive dialogue would be stipulated in some guidelines [not the Code itself]. I feel sorry for pointing out small faults, but I think we should write about these matters, because at the moment, there is a huge recognition gap between the management and investors. To make the Stewardship Code and the Corporate Governance Code work effectively as two wheels of a cart, I’d like to request that the Code provides certain descriptions about such very primitive level disclosure. That’s all.

[Ikeo, chairman] Thank you. Mr. Mori, please.

[Mori, member] Thank you. As some other members already mentioned earlier, because there is a principle of the equal treatment of shareholders, the companies must be extremely careful about disclosure. I, therefore, believe that we need a certain framework of information disclosure, although it may not be a topic of our discussion.

There already is a framework for disclosure of financial information, but I assume a framework for non-financial information does not exist or is not sufficient. According to the media report, approx. 100 companies disclose information through so-called integrated reporting. The reality is, however, that there is no clear framework for non-financial information, and thus it may cause a problem of corporate responsibilities for disclosure. Therefore, I think there is a growing need to discuss an institutional framework for the integrated reporting in the future. At the moment, I also think the Code should refer to it in order to encourage corporate efforts for proactive disclosure.

Risks associated with information are higher in prospective information, compared to historical information, so I think companies need to examine this issue.

[Ikeo, chairman] Yes, please go ahead.

[Uchida, member] As for fair disclosure of information, every company pays careful attention, and makes sure not to disclose excessive information only to a certain party. Basically, they have disclosable information at hand, and fairly make disclosure based on it.

Regarding disclosure of the capital efficiency level, etc., if companies want to attract investors to make medium to long-term investments toward sustainable corporate growth, companies naturally need to disclose medium to long-term business strategies and earnings

target, and to have dialogue on such matters.

It was pointed out earlier that top management and the board do not really look at shareholders, but nowadays companies are actively promoting their IR activities. I think consciousness of shareholders among Japanese management is growing, and thus the companies are increasingly using ROE as an indicator of their capital efficiency.

However, considering the balance with other stakeholders, the sole use of ROE is insufficient and biased. It is important to set a standard by using ROE together with other indicators such as ROA, ROS, D/E ratio, taking a balance from a comprehensive viewpoint. In that sense, investors may also be "one of them", but please consider my suggestion.

[Ikeo, chairman] Time is running out. If you absolutely need to share your opinion… Mr. Oba, please go ahead.

[Oba, member] I'm not sure if this is absolutely necessary, but I'd like to make comments in response to Mr. Uchida. It does not mean that the companies should look at only investors. To take a balance [among various stakeholders], the companies have not paid sufficient attention to investors. Therefore, it should be corrected. I'd like you to see it as the reinforcement of equity governance.

Today we have discussed disclosure, functions and dialogue separately. Yet these are actually inter-related. I'm not sure which topic best suits my point, but one thing we need to recognize is the fact that shareholders evaluate companies very strictly. This is the fact, not my opinion. In this regard, I think it is important to clarify such issues as which functions the board has fulfilled or not fulfilled, and to which matters each one of directors (including outside directors) has contributed or not contributed; and then share such issues through dialogue with investors. In my opinion, unless we look at disclosure, assessment/ evaluation, functions and dialogue as a set and consider how the entire cycle works well, the Corporate Governance Code would not work effectively, I'm afraid. So I'd appreciate it if a statement to this effect was included in the Code.

[Ikeo, chairman] Although we still have plenty to discuss, the time is already up. I'd like to close the discussion now.

In the next Council, we will discuss specific matters related the Responsibilities of the board, such as institutional designs, structure, procedures, and training, which enable directors and senior managements to perform their responsibilities. Furthermore, taking into account

what we have discussed so far, if you find anything which needs to be further discussed, please point it out.

Thank you very much for your active discussion today. As usual, if you have any additional opinions which you could not share today, please send them by post or e-mail to the secretariat. Your comments are always welcome.

Finally, I'd like to ask the secretariat to make any necessary announcement.

[Yufu] The next Council is tentatively scheduled to begin from 14:00 on Friday, 31 October, although the secretariat is still coordinating the schedule. We will inform you of the details later.

[Ikeo, chairman] Thank you very much. Now I declare today's Council closed. Thank you very much for your cooperation.

End