Opinion Paper for Drafting the Corporate Governance Code
(for the Seventh Council of Experts)

November 25, 2014
Kazuhiko Toyama

This Council will discuss the most important point at issue in reforming corporate governance. As the Vice Chairman of one of the three main economic associations in Japan - the Japan Association of Corporate Executives - and as a representative of financial experts and industrialists, here I will give my opinion on the said point at issue, following the Opinion Paper [1] that was recently officially presented by the Japan Association of Corporate Executives with regard to drafting the Corporate Governance Code.

1. General statement

First of all, as a general statement, **and as is made clear in the Opinion Paper, I should point out that many financial experts share the view that the drafting of a truly innovative Corporate Governance Code constitutes a key core strategy of Abenomics, intended to foster sustainable economic growth as an engine for companies' earning power.**

That is to say, in addition to the preceding drafting of the Stewardship Code, the yen's depreciation through unprecedented monetary easing, and the ongoing reform of GPIF and corporation tax, the drafting of the Corporate Governance Code is seen as one of the essential key policy challenges in creating, through improving the earning power of Japanese enterprises and raising share prices steadily over the long term, the following virtuous circle: boost corporate performance ⇒ boost the productivity of capital and labor ⇒ boost wages and household assets ⇒ boost consumption ⇒ boost investments.

Or, to put it the other way around, **many financial experts and industrialists share the view that, if the Code ends up preserving the status quo with regard to today's point at issue, we will betray the expectations of both Japanese and foreign stakeholders of Japanese listed companies, and risk slowing the momentum of a core growth strategy of Abenomics.**

Therefore, the Code should not be the product of compromises reached to conform to the current state of our companies, but, rather, should gather best practices among Japanese businesses and point the way towards an optimal corporate governance.

[1] In October 2014, the Japan Association of Corporate Executives published its Opinion Paper on the Corporate Governance Code. The Opinion Paper was submitted as Material 2 for the Fourth Council of Experts.

2. Itemized discussion

(1) Approach (General Principle 4)

At the Sixth Council of Experts, we discussed that the Code should describe the fact that the majority of Japanese companies are Companies with a *Kansayaku* Board.

This is certainly true of the majority of listed companies. Out of these, however, best-practice companies that are highly regarded by the market for their outstanding governance are not sticking to the conventional model of a Company with a *Kansayaku* Board, but rather, are endeavoring to resolve the model's issues (for example, the grave limitations to the monitoring function of the *kansayaku* board, which legally does not have decisional authority over the appointment and dismissal of executives). Aiming to effectively implement independent and objective monitoring, they are taking a variety of measures to achieve better governance, incorporating advantageous aspects of Companies with Three Committees (that is, for example, the use of independent directors, and the establishment of a nomination advisory committee and a compensation advisory committee). In other words, **even if the majority of listed companies are in fact Companies with a *Kansayaku* Board, it must be said that such companies suffer from systemic corporate governance defects in terms of their ability to ensure independent and objective monitoring at the board of directors, and the fact that Companies with Three Committees are in some ways superior** is undeniable.

In this sense, companies must not neglect efforts to improve their governance, and, as stated in the Secretariat's proposal, it will be important for them to devise ways of ensuring that each body substantially and thoroughly performs its functions. **Wording that encourages companies to preserve the status quo must be avoided at all costs as it may give the mistaken idea that such efforts are unnecessary.**

If the Code were to state that most listed companies are Companies with a *Kansayaku* Board, then it should also point to the defects of Companies with a *Kansayaku* Board from the standpoint of their monitoring function. Of course, all three types of institutional design are approved under the Companies Act, and should be treated equally when drafting the Code, and therefore any defects in the monitoring function of Companies with Three Committees and Companies with an Audit and Supervisory Committee should be indicated.

(2) Effective use of independent directors (Principle 4.8)

As stated in the Opinion Paper, financial experts and industrialists recognize that independent directors, combined with a nomination advisory committee and a compensation advisory committee (discussed below), are a necessary presence at the core of governance, and that it will be necessary to bolster their role.

Therefore, the minimum number of independent directors should not stop at one as stipulated by the Companies Act, but should, rather, be brought up to ensure the

presence of at least two independent directors.

Furthermore, the idea of requiring the appointment of additional independent directors depending on the board of directors' composition is supported by many financial experts and industrialists. In view of this, **at least one third of directors should be independent directors, appointed on a voluntary basis and upon comprehensively taking into account the company's characteristics and other elements.**

(3) Use of Discretionary Arrangements (Principle 4.10)

By now, financial experts and industrialists find themselves in agreement that reinforcing corporate governance will help Japanese companies, which find themselves less and less competitive in the increasingly intensifying global competition, to regain their competitive edge. The Opinion Paper also stresses the importance of 'offensive governance' as a means of providing the improved growth potential and earning power required for global competitiveness.

Therefore, with regardto appointments and remuneration - important points in offensive governance - **as stated in the Opinion Paper, companies should set up a nomination advisory committee and a compensation advisory committee composed by a "majority" of independent directors.**

Accordingly, the Code should clearly indicate that the Secretariat's proposal that "(committees) should be composed mainly of independent directors" mean that independent directors should be make up for at least the majority. Also, the Secretariat's proposal reads: "for example, optional advisory committees (...) can be placed under the board of directors." The establishment of a nomination advisory committee and a compensation advisory committee, however, should not be indicated as an "example", but, rather, as a best practice of corporate governance in accordance with the 'comply or explain' rule.

(4) Intensifying "autonomous" governance (concerning Principle 4)

The Secretariat's current proposal emphasizes "heteronomous" governance imposed from outside the company by stipulating specific requirements with regard to the roles and responsibilities of independent directors and dialogue with shareholders. The proposal, however, seems to lack specificity in dealing with "autonomous" governance imposed from within the company. **Corporate governance is achieved through a balance of 'heteronomy' and 'autonomy', and the Code should stipulate this specifically.** In particular, CFOs should be mentioned, as they are expected to function as brakes while the CEOs push on the accelerator, and thus serve as an important element of autonomous governance.

(5) Cross-shareholdings (Principle 1-4)

Although the Opinion Paper fails to mention this, the Japan Association of Corporate Executives has long treated the elimination of cross-shareholdings as one of the challenges to be faced in reforming corporate governance[2]**.**

This is because of the undeniable risk of cross-shareholdings making corporate governance meaningless (with concerns, for example, over the exercise of voting rights straying from the rights of common interest, and suspicions of profit sharing for specific shareholders in relation to the proportionality of compensation entailed by transactions), and because of the resulting awareness of the necessity of eliminating this type of shareholding unless conducive to the continued improvement of corporate value.

The Code should therefore state that listed companies **should eliminate cross-shareholdings unless there are specific circumstances whereby the possible returns outweigh the risks, contributing to improving corporate value; in such cases, they should clearly and specifically disclose and explain to shareholders the fact that returns outweigh risks**. Furthermore, the Code should stipulate that listed companies must engage proactively in dialogue with their shareholders, and consider their shareholders' views in dealing with cross-shareholdings.

Moreover, **listed companies should draft and disclose criteria for exercising voting rights for cross-shareholdings, as well as basic policies for announcing the results of the exercise of voting rights.** In view of a company's fiduciary responsibility toward shareholders, there is no reason to stipulate any differently compared to the principles outlined in the Stewardship Code.

(6) Period of application (preamble)

As stated in the Opinion Paper, **the Corporate Governance Code's application should begin in FY 2015 in accordance with the Japan Revitalization Strategy**. Companies that require some time to secure independent directors should present a road map indicating the time frame within which they are going to do so. This has been provided for in the Opinion Paper of the Japan Association of Corporate Executives.

(7) Ensuring the appropriate disclosure and transparency of information (General Principle 3)

The Secretariat's proposal states that "listed companies must disclose information on management strategies and tasks, risks/governance and other non-financial information in an appropriate fashion and in accordance with laws and regulations." However, this risks causing misunderstandings, as the disclosure of some of the non-financial information mentioned is not required by laws and regulations.

While the efficiency in disclosure in accordance with laws and regulations should

[2] In its "Reforming Corporate Governance with the Aim of Bolstering the Foundations of Corporate Competitiveness" (July, 2002), the Japan Association of Corporate Executives states: "We hope that institutional investors will help eliminate cross-shareholding, broaden the individual shareholder base, and present their opinions purely from the standpoint of investors, serving as "active shareholders"."

be promoted, in order to make dialogue and engagement with shareholders more effective it will also be important to encourage companies to disclose information on a voluntary basis; and it is essential to state this so as to avoid any misunderstanding on legal requirements.