

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

1. Date and Time: March 9, 2021 (Tuesday) 15:30-18:00
2. Venue: 9F, Central Government Building No. 7, Meeting Room

[Kanda, Chair] Well, I'd like to open the twenty-fifth Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code.

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

As you may have already known, Professor Kazuhito Ikee, who had served as Chairman of this Council for many years, passed away on February 21. We remember the contributions he made in his lifetime, and would like to express our deep condolences.

Today, the representative from the Financial Services Agency (FSA), in the capacity of the Secretariat, will explain two Materials "Ensuring Confidence in Audits/Internal Control and Risk Management" and "Other Issues" and then we will have discussions.

And today, Ms. Waring will express her opinions in English. In the same manner as the previous time, we will provide the consecutive translation service.

Now I'd like to ask the FSA representative to explain two themes "Ensuring Confidence in Audits/Internal Control and Risk Management" and "Other Issues", Mr. Shimazaki, I'm giving the floor over to you.

[Shimazaki, Director of the Corporate Accounting and Disclosure Division, FSA] I'll explain Material 1 and Material 2.

I'll start from Material 1 "Ensuring Confidence in Audits/Internal Control and Risk Management".

Please turn to page 2, which is general overview.

In this section, we summarized the current Principles of the Corporate Governance Code, which is associated with ensuring confidence in audits and internal control.

The Corporate Governance Code first states it is important for the board of a listed company to fulfill its roles and responsibilities for ensuring confidence in audits and appropriately establishing the internal control and risk management system, and discusses details mainly in Section 4. The audit

here refers to auditing business operations and accounting.

On page 3, we quoted General Principle 4. Here, we'd like to emphasize the fact that the Code stipulates that such roles and responsibilities should be equally and appropriately fulfilled regardless of the form of corporate organization (“organizational form”) – namely, Company with *Kansayaku* (audit and supervisory board members) Board (Audit & Supervisory Board), Company with Three Committees (Nomination, Audit and Remuneration), and Company with Supervisory Committee.

At the bottom of the page, the excerpt from the Preamble is also cited. It reads, “The Code does not express a view on any of these forms of company organization. It specifies fundamental principles for corporate governance that should be applicable to whichever form of organization a company may choose.”

While a number of principles are stipulated under the assumption that the form of Company with *Kansayaku* Board is chosen, it is anticipated that companies that take a form other than Company with *Kansayaku* Board will apply these principles by making necessary adjustments in accordance with their form of company organization.

On page 4 and page 5, we summarized the member composition, audit method, and other characteristics of each audit body, namely, *Kansayaku* board (Audit & Supervisory Board), Supervisory Committee, and Audit Committee, as mentioned earlier. You can see the corresponding organizational form, primary position of the members [i.e. *kansayaku* or director], membership, the scope of auditing, and so forth.

On page 5, we visualized the structure of each organizational form. In the “Overview” section, key points related to the supervision and business execution for each organizational form are written in blue font.

On page 6, you can find the structures of corporate governance codes of other countries, in terms of how the chapters are organized. Some countries have an independent chapter [for auditing/internal control and risk management], and other countries, including Japan, stipulate such matters in a chapter dealing with roles of the board. Specific descriptions of these codes are shown on a later page.

The section from page 7 is about coordination and cooperation in auditing between *kansayaku* or the like [i.e. *kansayaku*, audit committee members, and supervisory committee members] and the internal audit department.

On page 8, we cited excerpts from the Follow-up Council's Opinion Statement No. 4 published in April 2019. It was stated that "defensive governance" is indispensable to realizing the sustainable growth of companies and their mid- to long-term increase in corporate value, and the Council will review measures for ensuring confidence in audits.

As shown in the excerpts below, ensuring confidence in audits is an extremely important prerequisite [to this defensive governance]. Therefore, it is important to promote the establishment of processes where the internal audit department directly reports to the board which includes independent directors, Audit Committee, *Kansayaku* board (Audit & Supervisory Board), etc. so that internal audit effectively works with a certain level of independence. That's what was written in the Opinion Statement, and we expect you will discuss related matters this time.

Now I'm moving on to page 9, which shows examples of coordination and cooperation in auditing between *kansayaku* or the like and the internal audit department.

In light of the awareness of the issue which I mentioned earlier, a survey of practical examples was conducted to find out how *kansayaku* or the like and the internal audit department cooperate on auditing. For each of Company with *Kansayaku* Board (Audit & Supervisory Board), Company with Three Committees (Nomination, Audit and Remuneration), and Company with Supervisory Committee, the survey found out reporting practices concerning the status of individual audits and the summaries of audit results for a certain period of time. You can see some examples of such reporting practices in terms of the frequency and patterns on this page.

Page 10 is about direct reporting lines. In 44.9% of companies, the internal audit department has a direct reporting line to the board, (board of) *kansayaku*, or Audit Committee, etc. in addition to President.

Please turn to page 11, which is about the size of the internal audit department. As for the number of staff members in the internal audit department in charge of auditing either a company group or an individual company, companies which have less than 5 staff members account for roughly 40% in both cases.

I'm moving on to page 12. In connection with the system of the internal audit department, this page shows disciplines on the internal audit department, including reporting lines for internal auditing, in other countries. For example, some codes stipulate that, in case an internal audit function has not been established, such companies should explain how adequate assurance of the effectiveness

of the internal control system has been obtained. As for the reporting line of the internal audit department, which is one of the issues to be discussed at this Council, some codes stipulate that the [primary] reporting line is to the board or Audit Committee. For example, OECD Principles and the UK guidance refer to such reporting lines.

The section from page 13 is about internal control and risk management.

On page 14, we summarized existing opinions on internal control and risk management. As mentioned earlier, the Corporate Governance Code requires the board to appropriately establish the internal control and risk management system. When we conducted interviews, it was pointed out that, with respect to the risk management, it is important for the board to appropriately decide on and evaluate risk-taking from the perspective of increasing corporate value. While specific opinions are summarized below, it was suggested that it is important to work on internal control and risk management by more consciously recognizing them as a matter of governance.

As shown in the Material, there is an opinion that we should not focus only on negative implications of risks. [On page 15], we summarized past discussions on internal control and risk management as well. Until the '90s, there was a traditional approach to the risk management, which focuses mainly on negative implications of risks and places an emphasis on how to avoid/control risks. However, since the '90s, the modern approach to risk management has been discussed, for example, at the Basel Committee. The modern approach places an emphasis on managing risks by comprehensively looking at risks in terms of both positive and negative risks.

Such a trend can be seen in the US and the UK as well. COSO's "Enterprise Risk Management – Integrated Framework" in 2014 is one example. In the UK, in discussion of corporate governance, the Hampel Report and its practical guidelines named "Turnbull Guidance" stipulated, so to speak, the growth-oriented perspective: [the importance of corporate governance lies in] its contribution to business prosperity, and a company's board is expected to adopt a risk-based approach. COSO regarded risk appetite or risk tolerance as a fundamental part of setting strategy and objective, I think.

I'm moving on to page 16, which shows the view of COSO in the US, which develops an international framework of internal control. COSO stands for the Committee of Sponsoring Organizations of the Treadway Commission.

With respect to governance on internal control and risk management, internal control is an indispensable part of enterprise risk management, and enterprise risk management is an integral part

of governance. In the square diagram which is cited in various literature, governance is recognized as the overarching concept.

On page 17, you can see the trend of the internal audit department of global companies. We summarized global companies' characteristics in terms of the involvement of the internal audit function in risk management and so forth. For example, the scope of internal audits includes all risks associated with the entire businesses. There is a typical feature of reporting lines. In the table below, we described characteristics of global companies, in terms of the internal audit department' roles, human resources development, organizational structure, and emergency response.

On page 18, you can see disciplines [on internal control and risk management] in codes of other countries. As mentioned earlier, some codes stipulate that [a company's board should] make decisions on the nature and scope of risks the company takes from the perspective of increasing corporate value, instead of negative implications. That is about risk appetite.

OECD uses such an expression as risks which a company tolerates in pursuing its objectives. ICGN uses such an expression as the board's agreement on its risk appetite. In the UK, the Netherlands, and Singapore, etc., they use such an expression as key risks that a company is willing to accept in the pursuit of its strategic objectives.

Taking these points into account, we propose issues to be discussed at today's meeting, as described on page 19. It has been pointed out that in order to increase mid- to long-term corporate value, it is important to ensure confidence in audits as the foundation for that.

And, with respect to internal control and risk management, while the Corporate Governance Code stipulates that the board should appropriately establish the internal control and risk management system, there are opinions bearing in mind that:

It is important to have the perspective that a company's board should appropriately assess and make decisions on risks which the company takes for the purpose of increasing corporate value, instead of merely looking at risks from the perspective of reducing negative factors, such as loss prevention;

It is important to work on internal control and risk management with an increased awareness that it is a matter of governance.

Taking such opinions into consideration, we'd like you to share your views on the following issues.

What do you think about the coordination/cooperation in auditing between *kansayaku*, etc. and the

internal audit department?

What do you think about an ideal way of internal control and risk management in light of corporate strategies, etc.?

Are there any other issues to be discussed concerning ensuring confidence in audits and internal control and risk management?

Now, I'll explain Material 2 about "Other Issues".

Please turn a page to go to Section (1) governance in accordance with new market segments.

First, we cited excerpts from the [current] Securities Listing Regulations of the Tokyo Stock Exchange. For example, as for companies listed on the First or Second Section, they are required to either comply or explain reasons for non-compliance with General Principles, Principles, and Supplementary Principles of the Corporate Governance Code. As for companies listed on Mothers or JASDAQ, applicable principles are limited to General Principles. These are stipulated in the Securities Listing Regulations.

The next several pages were already included in the Material for the 21st Follow-up Council, but let me briefly explain the overview of the new market segments once again. Under the new market segmentation, there will be the Prime Market, the Standard Market, and the Growth Market, although all names are tentative. With respect to corporate governance, since Prime Market-listed companies are required to pursue a higher standard of governance, all principles [i.e. General Principles, Principles, and Supplementary Principles of the Code] apply to them. As for Standard Market-listed companies, all principles apply. As for Growth Market-listed companies, General Principles apply. As shown on pages 4 and 5, I understand that such requirements are based on the report issued by the Expert Study Group on Capital Markets in Japan of the Financial System Council, which summarized its discussions on the concept of the Prime Market, listing criteria, and so forth.

Page 6 was also included in the Material for the 21st Follow-up Council. At that time, I talked about what kind of viewpoints should be taken when we consider a higher level of corporate governance to be required for the Prime Market, as well as major recommendations of the Expert Study Group on Capital Markets – for example, requirements related to independent directors, Nomination Committee, Remuneration Committee, and disclosure in the English language.

Page 7 shows an excerpt from this Council's Opinion Statement (5) published in December. It first states that this Opinion Statement provides recommendations on some issues for inclusion in the next

revision of the Corporate Governance Code, with the aim of demonstrating a higher level of governance under a 'Comply or Explain' framework. And then it refers to a higher standard concerning independent directors to be applied to the Prime Market after the transition to the new market segmentation.

From page 8, we summarized opinions expressed at this Council concerning the pending issues of the board effectiveness as well as new market segments. For example, opinions about the composition and roles of committees, and the roles of Chair are summarized here. On page 9, you can see opinions about the electronic voting platform, disclosure in the English language, etc.

As issues to be discussed today, in light of such discussions, we'd like to know your opinions about governance required for Prime Market-listed companies, as well as Standard or Growth Market-listed companies, especially from the following viewpoints.

While the revised Code is to require Prime Market-listed companies to ensure a higher level of governance, what do you think about governance required only for Prime Market-listed companies, compared to governance required for Standard Market-listed companies?

In case of Growth Market-listed companies, basically only General Principles will apply in the same manner as before. Then what do you think about governance commonly required for not only Prime or Standard Market-listed companies, but also Growth Market-listed companies?

In Section "(2) Others", page 12 is the repost from the Material for the 21st Follow-up Council. These are the issues that were proposed for discussion, and you have actually discussed such issues so far.

As shown on page 13, if there are any other issues that should be discussed toward the revision of the Corporate Governance Code, we'd like you discuss such issues.

That's the explanation of Material 2. That's all from me.

[Kanda, Chair] Thank you very much.

Now I'd like to start the discussion session and hear your questions and opinions. Today I'd like you to discuss mainly the issues raised by the Secretariat, taking into account the explanation just provided. Specifically, such issues are written on page 19, which is the last page of Material 1, and page 10 of Material 2. I'd appreciate it, if your questions or comments focused on those points.

As usual, please note that the allotted time for each speaker is 5 minutes or so. I'd appreciate your cooperation.

If you would like to speak, please send a chat message to all participants, specifying your name. If Ms. Waring is online, I'd like her to speak first.

[Waring, member] Thank you. I'd like to thank Chair Kanda and the Council members for giving me an opportunity to share ICGN's views on the subjects of risk oversight, ensuring confidence in audits, and key governance standards for Prime Market-listed companies in today's Council meeting.

First of all, with respect to risk management, the board should proactively assess and disclose the company's key risks, and its approach to internal control and risk management on an annual basis or upon a significant change in its business. It includes an assessment of the potential probability and impacts of such risks, as well as mitigating actions and procedures. Risk oversight should be enterprise-wide and cover a whole range of threats, including those to the company's business model, performance, solvency, liquidity and reputation. In other words, risk oversight should extend beyond financial capital to include human capital and natural capital. Risk should be appropriately reflected in the company's strategy and capital allocation. Risk should be managed in a rational, appropriately independent, dynamic and forward-looking way. The board should lead by example and foster an effective risk culture that encourages openness and constructive challenge of judgments and assumptions.

With respect to ensuring confidence in audits, the board should establish rigorous, independent and effective internal and external audit procedures, to ensure the quality and integrity of corporate reporting, and to enable shareholders and stakeholders to assess the company's financial position, performance and long-term prospects.

As for internal audit, the board should oversee the establishment [and maintenance] of an effective internal control system to properly manage risk, which should be measured against internationally accepted standards periodically for its adequacy. In case an internal audit function has not been established, full reasons for this should be disclosed in the annual report, as well as an explanation of how adequate assurance of the effectiveness of the internal control system has been obtained.

Audit Committee should be comprised entirely of independent non-executive directors. At least one member of the Committee should have recent and relevant financial expertise, and all members should be financially literate.

Audit Committee should oversee the integrity of financial statements, and review the company's risk management approach, internal control system, and the effectiveness of the internal audit

function.

Audit Committee should establish procedures to ensure an effective and independent external audit of the company's financial statements, and provide assurance to shareholders and stakeholders around the company's financial position, performance, and prospects.

Audit Committee should engage the external auditor without management present to discuss any risks or other concerns that are significant to the audit process, including issues on accounting, internal control and risk management. The Committee's work should be reported in the annual report, explaining significant issues arising from the audit relating to the financial statements and how they were addressed.

The annual report should also include an external auditor's statement which provides an independent and objective opinion as to whether the accounts give a true and fair view of the company's financial position and prospects.

The appointment of an external auditor should be approved at the annual general meeting of shareholders. In such an occasion, Audit Committee should report to shareholders on the effectiveness of the audit process including audit tender, auditor tenure, independence, fees, and the provision of any non-audit services.

With respect to which Corporate Governance Principles should be prioritized in the standards for the Prime Market, we have made a number of recommendations previously. For brevity, we have refined this to 10 priorities.

First of all, we maintain our position that the board should comprise a majority of independent directors. This is particularly important for listed subsidiaries. In Japan, the number of listed subsidiaries is higher compared to other countries. In this context, the majority of independent directors act as a check on the presence of a holding company shareholder.

Second, there should be a clear division of responsibilities between the role of the chair of the board and the CEO to avoid unfettered powers of decision-making in any one individual.

Third, the board should appoint a lead independent director, who provides shareholders, stakeholders, and directors with a communication channel, for example, when they wish to discuss concerns relating to the chair or controlling shareholders in the case of controlled companies.

Fourth, in light of the company's policy on diversity among directors and other employees, the board should disclose and report on the progress against the policy, including measurable targets and

period for achievement, while ensuring the alignment with the company strategy and succession planning.

Fifth, Nomination Committee should lead the formal and transparent process for appointing directors, to ensure appropriate refreshment of directors.

Sixth, the board should disclose a clear policy on the company's approach to capital allocation, as a foundation for long-term value creation. In this perspective, IGCN welcomes the proposals by the METI for an annual, data-led review of a company's business portfolio by the board.

Seventh, we'd like to suggest that disclosure on cross-shareholdings should be improved. Companies should clarify the nature of cross-shareholdings, and provide a rationale for the cross-holdings. They should describe how they will reduce cross-shareholdings over a specified period of time.

Eighth, the Security Report should be published before the AGM, including the English version.

Ninth, information related to corporate governance should be consolidated into the Securities Report, and the use of XBRL tags should be encouraged to make analysis more efficient.

Tenth, we consider that the Financial Instruments and Exchange Act needs to be reviewed regarding public takeovers. In other words, we believe that appropriate minority shareholder protections should be ensured. We are aware that this is a matter of hard law, not necessarily the Corporate Governance Code.

Furthermore, we believe it is critically important for boards to enter into constructive dialogue with shareholders. Sharing mutual interests, both companies and investors should be responsible for increasing long-term corporate value. We believe that doing so will lead to sustainable economic growth and prosperity of the society.

That's all. Thank you.

[Kanda, Chair] Ms. Waring, thank you very much for sharing your invaluable opinions.

Now I'd like to hear questions and opinions from other members. When you want to speak, please send a chat message to all participants. Who would like to speak?

Thank you. Mr. Obata from NEC, please go ahead.

[Obata, member] Thank you for allowing me to speak first. I'd like to make comments on all subjects in the order of the list.

As for the first point about confidence in audits, I have the same opinion about the coordination

with the internal audit department. Furthermore, I feel that the accounting auditor should be included here, and it is even more necessary to ensure the coordination and cooperation among three parties – [*kansayaku* or the like], the internal audit department and the accounting auditor. Consequently, I consider that *kansayaku* audits will be enhanced by using various information from internal auditing and the accounting auditor’s opinions.

From that perspective, the internal audit department must report audit results to the board. And as explained earlier today, if the number of staff members is only 5 or so, I don’t think adequate internal audits are possible. I believe that the enhancement of the internal audit department is a very important factor required for companies.

As for the second point about risk management, risks surrounding companies have been significantly changing these days. Probably, companies are becoming unable to respond to such risks through their traditional approaches. The board should properly oversee whether the company adequately identifies risks within the company, and whether an appropriate system for managing such risks is in place. I believe these are the responsibilities of the board, for the purpose of establishing the internal control system as well. So I totally agree with the opinions presented.

Next, as for other issues concerning new market segments, I personally feel that there should not be major differences in essential matters [of governance] regardless of whether companies are listed on the Prime, Standard, or Growth Market. Certainly, companies listed on the Standard and Growth Markets may include many startup businesses, so it would be appropriate to reduce their burden to some extent. However, the basic ideas should be the same regardless of whether companies are listed on the Prime Market or not. I think that’s the way it should be.

Finally, I’d like to raise some issues, which are not included in the Materials, for our future discussion.

As advocated by the METI, the digital transformation is becoming essential, and the METI issued the Digital Governance Code. I suggest that we should discuss the possibility of requiring companies to disclose to what extent they are working on it. This is the first one.

The second one is cyber security. Recently, cyber attacks have really been on the rise, so I suggest that we should have more in-depth discussions on corporate initiatives for the cyber security, which naturally include a system to manage confidential information.

Lastly, I think we need to further discuss business and human rights, which is often addressed in

the context of SDGs and ESG. I think it could be a new source of risk, so a further consideration will be required.

Let me make an additional comment. Currently, companies are required to satisfy difficult demands of the national security. I suggest that we should discuss corporate responses to such things in the future.

That's all. Thank you.

[Kanda, Chair] Thank you, Mr. Obata.

Next, Mr. Tsukuda, please go ahead.

[Tsukuda, member] This is Tsukuda.

First, I'd like to make comments on the coordination in auditing between *kansayaku* and the like and the internal audit department, as well as ensuring confidence in audits.

In the first place, there are two types of audit bodies depending on organizational forms of companies: one is *kansayaku* in Company with *Kansayaku* Board (Audit & Supervisory Board), where each member performs his/her role in auditing independently, not as an organization, and another one is Audit Committee or Supervisory Committee, which takes an "organizational audit" approach where the members work together for audits. Naturally, their relationships with the internal audit department are different. Accordingly, there is an issue of whether it is appropriate to discuss different organizational forms in a similar manner.

Therefore, I believe that the Corporate Governance Code needs to provide a separate guideline for each organizational form in a more careful manner. On this premise, I'd like to make 3 comments for ensuring confidence in audits.

The first point is about increasing the quality of internal audits. When we conduct evaluations of the board effectiveness, we still often feel the need for strengthening the function of supervisory bodies, namely, Audit Committee, Supervisory Committee, or *Kansayaku* Board (Audit & Supervisory Board). However, the function of Audit Committee and Supervisory Committee cannot be strengthened without strengthening the function of the internal audit department, which is on the business execution side. So, in order to ensure confidence in audits, increasing the quality of the internal audits is an absolutely necessary condition.

Then what is required for satisfying such a necessary condition? I believe it is important to allow Audit Committee or Supervisory Committee, which takes an "organizational audit" approach, to be

involved in personnel affairs of the internal audit department on the business execution side. Let me share an example with you. In one company, when an outside director accepted the offer to assume the position of the Audit Committee chair, he made such a condition to the president that the internal audit department should be headed by a top-level manager. The president accepted the condition, and consequently, the excellent Audit Committee chair and the excellent internal audit department head worked together to drastically strengthen the audit function.

There is a saying that “business is people” and I think this case is an example of “audit is people.”

The second point is about reporting lines of internal auditing. The internal audit department should report not only to the top executives, but also to Audit Committee, Supervisory Committee, or the board. In other words, dual reporting lines is an absolutely necessary condition. Among Japanese companies, dual reporting has been becoming more or less common. If there is a situation where the internal audit department reports only to the president, it should be improved urgently.

The third point is about overseeing the execution of duties of directors and executive officers, etc. For example, in the case of a Company with Three Committees (Nomination, Audit and Remuneration), where Audit Committee is well-functioning, Audit Committee has individual interviews with each of key management team members, including directors and executive officers, thoroughly monitors the execution of their duties, and honestly reports the results to the board. At board meetings, Audit Committee chair not only reports the status of implementing key management strategies, including business strategy, financial strategy, and HR strategy, but sometimes refers to organizational issues identified through the interviews or the corporate culture. In order to ensure that Audit Committee functions at this level, there should be 3 important things: first, secure excellent Audit Committee members who are capable of supervising the execution of duties from the management viewpoint; second, ensure that Audit Committee members commit sufficient time; and third, enhance Audit Committee’s reporting to the board.

I believe these 3 points are important in order to ensure confidence in audits.

Next, as for other issues to be discussed, I’d like to briefly make comments on the Prime Market. To consider this issue, we need to go back to the point described in the report issued by the Expert Study Group on Capital Markets in Japan of the Financial System Council, as explained earlier.

In the report, the Prime Market is defined as “a market for companies whose market capitalization and liquidity are large enough to attract investments from many institutional investors, that also have

a high quality of corporate governance, as well as commitment to sustainable growth and mid- to long-term increase in corporate value with a focus on constructive dialogue with investors.” Naturally, Prime Market-listed companies are required to satisfy such criteria as a certain level of market capitalization and liquidity, or higher governance standards, but I believe it is extremely important for the companies to focus on constructive dialogue with investors.

Then, specifically what does it mean – focusing on constructive dialogue with investors? In addition to such main actors of constructive dialogue as the management team, the IR department, etc., it is very important that independent directors also play a role in constructive dialogue with investors in case of Prime Market-listed companies.

From that perspective, as for General Principle 5, or Supplementary Principle 5.1.1 or 5.1.2, separate descriptions for Prime Market-listed companies and other companies can be provided.

That’s all. Thank you.

[Kanda, Chair] Thank you very much.

Next, Mr. Kobayashi, please go ahead.

[Kobayashi, member] Thank you.

I’ll talk about the internal audit department and risks first, and then go into other details.

As Mr. Tsukuda just mentioned, dual reporting is a matter of course for the internal audit department, and is of intrinsic importance. Page 10 of Material 1 revealed the fact that, in 427 out of 817 Japanese companies, the internal audit report is sent only to the president. This is a very serious problem, and such a situation needs to be improved promptly.

Furthermore, in Japan, there still remains a tendency that companies regard the internal control and risk management merely as defensive measures and are, therefore, reluctant to incur the costs. In Europe and the US, more human and financial resources are allocated to activities of the internal control function, Audit Committee, etc. I consider it is necessary to change such traditional Japanese mentality as well.

It is generally understood that Japanese companies are facing a fundamental challenge of how they undergo the portfolio transformation, based on such trends as carbon neutral and digital transformation, or in addressing various risks including the pandemic.

In this context, there are two types of risks: one is predictable risks, whose development we can clearly project, including carbon neutral, as well as declining population and labor shortage in the

future; and another is unpredictable and unexpected risks, including security incidents, cyber attacks, and natural disasters. Especially, for the manufacturing industry, it is important to have a hazard response plan, including training, in place to get prepared for such unexpected risks. Since there are various types of risks, it would be necessary to classify risks into several categories depending on their nature, and provide separate descriptions for each category [in the Code].

In addition, what level of risk tolerance does the management team consider is acceptable? In this regard, companies are expected to provide holistic and comprehensive narrative information, including their risk appetite, based on their classification of risks.

As for other issues to be discussed, during discussion at board meetings or dialogue with investors, I feel that in traditional Japanese titles of executives, including Vice President, *Jomu* (managing executive officer), and *Senmu* (senior managing director), it is difficult to understand the actual roles of such executives. In the Japanese language, *Jomu* literally means “always serving”, and *Senmu* literally means “serving full-time”. What’s the difference? Such titles are merely for the purpose of promotion by seniority. While such titles do not clearly represent the expertise or roles of the persons in question, the western-style titles for “C-Suite” – CFO, CTO, CIO, CSO, etc. – explicitly indicate what he/she does and what he/she is responsible for in a way external parties can understand. I think that changing title names this way would increase the effectiveness of the engagement with investors.

In this context, I feel that the right of representation is also a peculiar Japanese concept that is not easy to understand. In the manufacturing industry, if a serious accident occurs, in many cases, the company will take responsibility by the resignation of the director or directors in charge of manufacturing and security. Is the right of representation meant for taking such responsibility? In the Japanese society, there is an unspoken rule that, in order to assume the position of the chairperson of such industry associations as Japan Chemical Industry Association and Japan Petrochemical Industry Association, a candidate needs to have the right of representation. In a substantive sense beyond these cases, what is the right of representation for? I believe that fundamental discussion and explanation would be necessary for that.

Finally, let me repeat that, as generally understood, Japanese companies are questioned about how decisively they transform their portfolios in the midst of three major trends – carbon neutral, digital transformation, and pandemic. In such trends, considering that intangible assets, especially technologies and intellectual properties, in corporate value has become of importance more than ever,

I believe that not only the CEO and the CFO, but also the CTO should directly contribute to the engagement with investors, as a responsible party. I suggest that we should raise the awareness of such trends.

That's all.

[Kanda, Chair] Thank you very much.

Mr. Haruta, it's your turn. Please go ahead.

[Haruta, member] This is Haruta. I'd also like to talk about internal control and risk management, governance issues corresponding to new market segments, and other issues.

As another member mentioned earlier, according to page 10 of Material 1, there are 427 companies where the internal audit reports are not sent to other parties than the president. In addition, as shown on page 11, a significant number of companies have less than 5 staff members in the internal audit department. The number is smaller, compared to European and the US companies. I understand that there are huge differences in the internal control and risk management.

In that sense, I believe it is important to appropriately establish or improve the internal control and risk management system. Especially, reporting lines should be strengthened. Most importantly, it is necessary to increase the awareness of dealing with the internal control and risk management system as a governance issue.

While the environment surrounding companies is significantly changing due to COVID-19 right now, and while the industrial structure is changing due to the digitalization and carbon neutral, I assume that companies are required to strengthen their ability to address risks, including establishing a robust governance and audit system. I think it will lead to the sustainability of companies over the mid- to long-term.

Furthermore, as stated in the reference material, while there is no end to corporate scandals, the Whistleblower Protection Act was revised last year. Currently, discussions are underway concerning how companies should respond to the revised Act.

In this connection, I think that strengthening the whistleblowing system is a very important issue for companies.

In that sense, although it is already included in the Corporate Governance Code, it is necessary to further increase the effectiveness. There are some cases where a whistleblowing system exists merely for the form's sake, so it will become important to ensure the effectiveness of such a system in the

future.

Next, I'd like to make comments on the new market segments. I think it is very important to introduce the Prime Market, where higher governance standards are required. However, as I mentioned previously, I hope the Prime Market will lead the overall improvement of governance of companies listed on the Standard Market or the Growth Market. I hope that [such higher standards for the Prime Market] will contribute to raising the level of governance in all companies, instead of merely widening the gap of levels among companies.

As for other issues, as I mentioned in the previous meeting, while the industrial structure is rapidly changing, the restructuring of the supply chain is currently underway. Since very unfair trade practices are widespread, I believe that making trade practices more appropriate is very important from the perspective of the sustainability of the supply chain. From the standpoint of workers, we have been working on appropriate cooperation with stakeholders other than shareholders under the Corporate Governance Code. I consider that such clients as small and medium-sized companies are important stakeholders, so it is necessary to clearly define their positioning and enhance dialogue with them, thereby promoting fair trade practices and securing the sustainability of the supply chain.

Finally, I'd like to talk about ESG, as discussed earlier. ESG initiatives are important, and we pay close attention to them. Especially, with respect to labor and human rights, which are social factors of ESG, the workstyle reform will further advance in the future. Especially, due to the pandemic, the work environment and workstyles, including teleworking, will further change. I suggest that we should give in-depth consideration to social factors, including disclosures of information related to labor and human rights in this light, especially information on the work environment, and such discussion should be incorporated in the Corporate Governance Code.

That's all.

[Kanda, Chair] Thank you very much.

Now, Mr. Okada, I'm handing it over to you.

[Okada, member] This is Okada. In today's Material, I agree with the statement that defensive governance is indispensable for realizing sustainable corporate growth and increasing corporate value over the mid- to long-term. In other words, I understand that because of a robust defense in place, the management can take aggressive actions for the growth without worry. In that sense, strengthening defensive governance leads to growth-oriented governance.

We cannot consider defense without *kansayaku* and the internal audit department. In order to ensure their effective functioning, it is necessary to ensure their independence. Although the independence of *kansayaku* is stipulated in the Companies Act, in actual practice, full-time inside *kansayaku* are nominated by the president as a part of executive promotion. This is written on page 27 of the reference material [Material 3] as well. Accordingly, some of those who were appointed as *kansayaku* this way look at or care about only the president. When I talked with corporate managers and accounting auditors, some mentioned that they cannot expect much from *kansayaku*. In that sense, while ensuring confidence in audits, I think it is necessary, at the same time, to ensure confidence in *kansayaku* as well.

Meanwhile, there are many *kansayaku* who have been working hard for overseeing the management. Under the current situation where the business execution body has a strong power, however, *kansayaku* who have made overly-aggressive efforts may be forced to resign before the expiry of their tenures. I suggest that the Corporate Governance Code should be revised in a way to help such *kansayaku* demonstrate more competence.

As mentioned earlier, at the moment, whether governance works or not depends on the management. The responsibility of overseeing business execution rests with the board. Accordingly, discussions at the Follow-up Council tend to focus on strengthening the functions of the board. However, in many Japanese companies, a majority of directors are from inside the companies. Such directors are nominated by the president. This is the reality. Nomination Committee is not really capable of handling the selection of individual director candidates. In short, I think there is no guarantee that boards comprising a majority of inside directors can properly oversee the top executive, namely the president or the CEO.

Therefore, it is necessary to strengthen the oversight of executives by *kansayaku* and the internal audit department. We can expect them to play the role in overseeing the management by representing stakeholders.

For that purpose, it is indispensable to ensure the independence of *kansayaku* and the internal audit department substantively, not merely formally. The reason why I mentioned “substantive” is because the current Companies Act allows appointment of non-independent persons as *kansayaku*. Although there is a law to secure the independence of *kansayaku*, there remain issues with the implementation of the law by executives: in most cases, executives have control of the appointment and dismissal of

kansayaku. It is as stated on page 27 of the reference material [Material 3]. The Corporate Governance Code should emphasize that *kansayaku* should play a primary role in the appointment and decision-making on remuneration, thus helping *kansayaku* act proactively.

Another important function for overseeing executives is the internal audit department. However, in terms of the reporting line, in many companies, the internal audit department reports to executives, and is, therefore, not independent in reality. It is imperative for the internal audit department to report to Supervisory Committee and/or Audit Committee, but I hope it should also report to *kansayaku*. At least, I suggest that the appointment of the internal audit department head should require an approval of *kansayaku*.

Next, in the Corporate Governance Code, Principle 4.4 states that *kansayaku* should actively carry out their activities without interpreting the scope of their function too narrowly. In that sense, they are expected to participate in voluntary committees and express their views there, and actively participate in dialogue with investors, if requested. For that purpose, I suggest that Supplementary Principle 4.10.1 and/or Principle 5.1 should refer to outside *kansayaku* or *kansayaku*, in addition to independent directors.

It may be difficult [for *kansayaku* to participate in] dialogue with investors. Yet, upon the introduction of KAMs (Key Audit Matters), *kansayaku* have a role in discussing with the accounting auditor and take an initiative for determining KAMs. In the English language, such a function is called “those charged with governance”. Although *kansayaku* in Japan are not directors, they must perform such a function. When investors ask a company whether there is any risk information or negative information other than already-disclosed information, it should be *kansayaku* who can reply that the company has disclosed all relevant information. It would be *kansayaku*'s responsibility to ensure they can answer that the company has made necessary disclosures and determined KAMs as well.

As the third point, although this may deviate a little from today's discussion, I'd like to refer to opinions expressed by third-party committees in their reports on corporate scandals, as stated on page 21 of the reference material [Material 3].

As pointed out there, it is true that third-party committees have performed certain functions. However, there are such problems that committee members are selected by the party to the scandal, or executives who are related parties. It should be independent directors and *kansayaku* that oversee

such a third-party committee in terms of whether it functions properly. I'd like to bring up an issue that the Corporate Governance Code should refer to corporate scandals in one way or another.

Now I'd like to talk about new markets. I assume that companies to be listed on the Prime Market will receive significant investment from abroad. Since approx. two-thirds of such companies adopt the organizational form of Company with *Kansayaku* Board (Audit & Supervisory Board), I feel the need for avoiding the situation where overseas investors consider their governance is insufficient due to the lack of understanding of this organizational form. Therefore, in case Companies with *Kansayaku* Board intend to change their listings to the Prime Market, while adopting the management model, they need to change the concept of matters to be resolved by the board, and establish a system which enables prompt management decisions and is close to the monitoring model.

Companies making such efforts can maintain the principle of 'Comply or Explain', and additionally explain their efforts for improving their governance systems, as necessary.

That's all.

[Kanda, Chair] Thank you very much.

Next, Professor Kansaku, please go ahead.

[Kansaku, member] Thank you. I'll first express my opinion on ensuring confidence in audits.

With respect to the internal audit department, which is the 3rd line in the Three Lines of Defense model, it is suggested that the Code provides more specific and in-depth descriptions about its roles, and conditions for its effective functioning, especially cooperation between the internal audit department and such actors as the board, *kansayaku* or equivalent.

In the current Governance Code, Principle 4.3 titled "Roles and Responsibilities of the Board (3)" stipulates that the board should establish appropriate internal control and risk management systems. Furthermore, Supplementary Principle 4.13.3 stipulates that listed companies should ensure coordination between the internal audit department, directors and *kansayaku*. In other words, the current Code already refers to the need for cooperation between the internal audit department and the supervisory functions, namely the board and *kansayaku*, but in an abstract manner.

The internal audit department is expected to play its roles not only in internal control related to compliance and financial reporting, but also in finance, computing control and overall corporate management. Especially, I assume that the internal audit department is expected to proactively play the role in making proposals for improvements or new measures.

In the Practical Guidelines for Group Governance System (“Group Guideline”) published by the METI, in section 4.5 titled “Roles of *Kansayaku*, etc. Related to Internal Control System”, it states as follows: considering that it is effective to utilize the internal audit department in order for *kansayaku*, etc. to effectively perform their functions, the internal audit department should secure a direct reporting line to *kansayaku*, etc. in addition to a reporting line to executive management. And the Group Guidelines recommends that companies should stipulate, in their internal regulations, so-called dual reporting lines, where the internal audit department reports directly to *kansayaku*, etc. in addition to executive management.

In order to conduct useful and reliable internal audits, the internal audit department needs to be independent from the audit target. And since the scope of auditing is wide as mentioned earlier, high-quality audits will not be possible without securing sufficient number of staff members with diverse expertise.

Furthermore, in order to ensure the effectiveness of the internal audit function, it is considered that the Code could provide a specific description regarding the establishment of information channels where the internal audit department reports not only to executive management, but also directly to the board, *kansayaku*, and the accounting auditor. Considering that the role of the internal audit department, as the 3rd line of defense, is increasingly becoming important, I believe we should consider clarifying conditions for its effective functioning in a Supplementary Principle or something.

Next, with the market structure review, it is necessary and appropriate to require a higher level of governance of Prime Market-listed companies, and I’d like to emphasize the following 2 points.

It is considered that the core of corporate governance is the nomination of directors of the board and the management team as well as their remuneration. In this light, Nomination Committee and Remuneration Committee play especially important roles, and Supplementary Principle 4.10.1 of the current Code already requires companies to seek appropriate involvement and advice from independent directors by establishing independent advisory committees. As for companies to be listed on the Prime Market, even if they adopted organizational forms other than Company with Three Committees (Nomination, Audit and Remuneration), they should be required to establish optional Nomination Committee and optional Remuneration Committee, both of which comprise a majority of independent directors.

Particularly, the Code could clearly stipulate that Nomination Committee should play a central

role in selecting outside director candidates.

Secondly, with respect to the lead independent director, Supplementary Principle 4.8.2 of the Code already states that independent directors should endeavor to establish a framework for communicating with the management and for cooperating with *kansayaku* by, for example, appointing the lead independent director from among themselves. I believe it is appropriate that the Code, in principle, requires Prime Market-listed companies to appoint the lead independent director, and clearly states the lead independent director should perform an important function in constructive dialogue between the management and shareholders by serving as an intermediary between the management and institutional investors, in addition to the matters referred to in Supplementary Principle 4.8.2.

That's all from me. Thank you.

[Kanda, Chair] Thank you very much.

Next, Mr. Oguchi, please go ahead.

[Oguchi, member] Thank you. This is Oguchi.

Two materials are prepared for today's meeting, and I'd like to make some comments on "Ensuring confidence in audits/internal control and risk management" first.

I believe Japan's Corporate Governance Code delivers a strong message focusing on so-called "growth-oriented governance", taking into account the reality in Japan.

Meanwhile, in other countries, appropriate oversight of the management who tends to be inclined to excessive risk-taking is the essential part of governance. I'd like to first note that audit plays an important role in this light.

That said, there are two features of Audit Committee, on which global institutional investors place an emphasis: one is legal authority granted to directors, and another is the fact that all committee members are independent, as stated in NYSE's listing regulations, the UK's Governance Code as well as ICGN's opinion statement, which Ms. Waring explained earlier today. Behind this background, overseas investors understand that Audit Committee does not conduct its own audits; instead, using the legal authority of directors, Audit Committee lets the internal audit department conduct audits and report directly to the Committee. Because the internal audit department reports to independent Audit Committee, it can express opinions independent from business execution divisions. Overseas institutional investors regard Audit Committee as such a structure.

On page 4 of Material 1, we can see the overview of 3 organizational forms of companies under the Companies Act in Japan. Looking at the columns of who has the audit authority, I understand that the reason why the internal audit department reports directly to Supervisory Committee or Audit Committee which is assumed to use the internal control system is because of the requirement due to the respective organizational form.

On page 12 of Material 1, Singapore's case is described as an example. Similarly, the internal audit department functionally reports directly to Supervisory Committee or Audit Committee which belongs to the board. This is the primary reporting line. And for the administrative purpose, the department additionally reports to executive management, typically the CEO. I understand dual reporting lines this way. I think we should have common understanding of the dual reporting lines as well.

Japan's unique *kansayaku* system allows each *kansayaku* to exercise his/her authority independently. And they have a duty to select full-time *kansayaku* on *Kansayaku* board (Audit & Supervisory Board). Their strength is the fact that they conduct audits by themselves. That's how it was explained to me, and I understand these are the strengths of *kansayaku* system.

As a practical matter, looking at results of the survey by Japan Audit & Supervisory Board Members Association, the average number of *kansayaku* staff members in listed companies is very limited, so I can understand the need for cooperating with the internal audit department, and I think such cooperation should be promoted. However, considering the legal design whether the fact that *kansayaku* conduct audits by themselves is their strength, when they enhance cooperation with the internal audit department, I think the Code should provide two different explanations for 'kansayaku' and 'Supervisory Committee and Audit Committee' which are required to do so due to their organizational forms.

Next, as other issues, I'd like to make some comments on the Prime Market.

Since it is advocated that the Prime Market requires a higher level of governance standards, there is a need for efforts to obtain global understanding. I'd like to make 2 comments from that perspective.

One is the role of the board chair. In ICGN's opinion statement dated November 18, and in today's presentation on ICGN's opinion statement by Ms. Waring, particularly in 10 priorities, ICGN recommends that the board should be chaired by an independent director who should be independent on the date of appointment. For the purpose of increasing the effectiveness of the board, I understand

that the independence and leadership are required of the board chair after undergoing global verification. Under such circumstances, while Japan's Code similarly calls for the board effectiveness, the Code does not contain an explanation of the independence of the board chair. I wonder whether it is adequate when a higher level of governance standards is required.

Let me talk about practical matters. Like I said, companies do not care about the independence of the board chair, and do not provide any explanations in their convening notices for general shareholder meetings. Consequently, for example, overseas investors, who exercise their voting rights focusing on the independence of the board chair, remain in a situation of insufficient information, and this problem has not been resolved.

On the other hand, it is true that only a limited number of Japanese companies have the independent board chair. Then, from the viewpoint of being realistic to Japanese companies and achieving international recognition, it may be worth considering Singapore's standard for the Prime Market in Japan: specifically speaking, if the board chair is not independent, the board should comprise a majority of independent directors.

Another point is about spreading out the dates of general shareholder meetings (AGMs). As discussed at the Follow-up Council on December 8, under the current practice where an AGM must be held within 3 months from the fiscal year-end date, it is clear that, even if companies try to further shorten the period from the dispatch date [of convening notice] to the AGM date, there will be a physical limitation.

Accordingly, as for the Prime Market, I suggest that the record date should be set by securing appropriate time from the fiscal year-end date to solve the problem of the concentration of AGM dates, and to facilitate the disclosure of Securities Reports before the AGM date, thus contributing to constructive dialogue with investors, which is another objective of the Prime Market.

That's all from me.

[Kanda, Chair] Thank you very much.

Next, Mr. Sampei, please go ahead.

[Sampei, member] This is Sampei. I'd like to make some comments on Material 1 "Ensuring confidence in audits/internal control and risk management" first. Although other members already mentioned it, I'd like to repeat that dual reporting is indispensable. The independence of the internal audit department is extremely important. And there are some cases where, although an internal

control system was established, it has lost substance, so it is necessary to review the effectiveness of the system.

In or around 2017, a number of corporate scandals were revealed, and I felt something was wrong. At that time, many companies in question counterargued that the incidents were in violation of internal regulations or contracts, but not laws or ordinances. The companies in question declared why they had to disclose investigation results to shareholders, and apologize at a press conference, and why their cases were regarded as corporate scandals. I felt strong discomfort with such counterarguments.

First of all, since shareholders and investors need to make judgments on whether they can trust investee companies to continue their investments, they naturally require information necessary for making such investment decisions. When they exercise their voting rights, they need to make judgments on whether they can maintain confidence in the management, so they naturally require relevant information. The management seemed to consider that, as long as there is no violation of laws, anything – say, a violation of internal regulations, a violation of a contract, or a failure of the internal control system – is not a problem or is an internal problem that does not require a disclosure. Such a way of thinking is not acceptable.

One reason for such scandals is the lack of dual reporting structure. For example, an incident was not reported to the board or other councils which include outside *kansayaku* and/or outside directors until one year after it was reported to the executive management inside the company; or even though an investigation was internally conducted, it was not reported to outside members. Therefore, I believe that dual reporting is indispensable.

In the meantime, with respect to risk management, we can see examples of highly advanced disclosures of risk management in recent Securities Reports. On the last two pages of today's reference material [Material 3], good examples of disclosures by a finance company and a manufacturer are provided. I hope many companies refer to such examples so that such disclosure practices will be widely adopted in industries.

Now I'm moving on to Material 2 related to the Prime Market. While a higher level of governance is required [of the Prime Market], how should it be disciplined? There will be 3 market segments, and the concept of such listing market segments is clarified. "Easy to understand" is an important factor to underpin the credibility of the market. Therefore, when considering how the Prime Market

should be disciplined, it is necessary to pursue the easiness to understand. However, considering that the Code has adopted the principle-based approach and its implementation is based on ‘Comply or Explain’ approach, I believe [all principles of] the Code should be applied to all market segments in common. This is my first point. The Code is applicable to listed companies, and has adopted ‘Comply or Explain’ approach, so it should be applied equally to all market segments. Companies have choices in selecting a market segment, and they select a market segment taking into account required criteria. Considering that companies can choose market segments, specific matters required of the Prime Market should be stipulated as rules in TSE’s Securities Listing Regulations, which require Prime Market-listed companies to comply with such rules.

As specific matters, I would say there are 8 items. Number one: disclosure in the English language. Number two: establishment of Nomination Committee and Remuneration Committee, each of which comprises a majority of independent directors. Number three: evaluations of such Committees’ effectiveness and disclosure of the evaluation results. Number four: review of the basic policy concerning business portfolio and relevant disclosure. Number five: disclosure on ensuring the mechanism to protect minority shareholders’ rights from the controlling shareholder. Number six: dual reporting by the internal audit department. When a considerable number of votes have been cast against a company’s proposal at the general shareholder meeting, the company needs to disclose its analysis of the reasons for ‘against’ votes, and an explanation on how the company considers such ‘against’ votes. Finally, number eight: companies should disclose their policies for diversity in both business execution and oversight sides, as well as ideal and actual states.

[The Secretariat raised a question about] how we consider the Growth Market. As I just mentioned, companies listed on the Growth Market should be subject to not only General Principles, but also Principles and Supplementary Principles. This is because they need to manage their companies taking into account their responsibility of using the public market as listed companies as well as governance required by the society. In case they cannot comply with certain principles, they can explain reasons for non-compliance. They have such an option. They can choose to provide an explanation. If they are allowed to observe only General Principles and ignore specific Principles and Supplementary Principles, the Growth Market will become a mere high-risk market.

Finally, as for other issues, while our discussion this time is meant for the second revision of the Code, I’d like to share the difference between the Code and rules in practice.

The underlying philosophy of the principle-based ‘Comply or Explain’ approach is to specify expected behaviors and, at the same time, not to micro-manage the implementation – rather, to encourage companies to use their creativity. Therefore, we need to be careful that the Code, despite its name, will not change into rules.

This time, you are using the expression that “a higher level of governance” is required of the Prime Market. However, considering the competition in the global market, what we are discussing now is just minimum standards. This fact should be widely recognized.

Then the goal of such minimum standards is not mere compliance. The companies are expected to establish and implement their own standards, which are higher than the minimum standards, and I believe that will lead to growth-oriented governance and an increase in corporate value.

That’s all from me.

[Kanda, Chair] Thank you very much.

Next, Mr. Oba, please go ahead.

[Oba, member] As other members already expressed various opinions, I’ll share my views focusing on two points.

With respect to how the importance of audits should be recognized, as everyone may have a common view, there are two points: one is ensuring the visibility of audit, another is audit by professionals. I think these are keywords.

Ensuring the visibility means enhancing disclosure of how audits are actually conducted. We could alternatively call it the effective visualization. Many good examples have already been introduced. It is very important to provide in-depth descriptions of activities, including specific audit focus, participants, time spent for audit, and whether it was an internal audit or accounting audit. That’s the way to promote what’s called visibility.

Another point is related to personnel affairs. As Mr. Okada reported audit issues, I believe it is important to shift to professional audits, instead of the current way where persons in charge of auditing conduct an audit as a part of signing a report. Ultimately, audits by professionals would lead to the independence [of audits].

Accordingly, I suggest that the Code should describe more specifically how the visibility of audits is ensured, as well as personnel affairs or the quality of audits, while the reference material refers only to the number of audit staff members. I hope everyone will understand what professionals means

in this context.

That's all.

[Kanda, Chair] Thank you very much.

Next, I'm handing it over to Ms. Matsuoka from Sony.

[Matsuoka, member] I'd like to make a brief comment in the capacity of the Chair of the Sub-Committee on Capital Markets of Keidanren (Japan Business Federation). Needless to say, this Council is the venue for discussion toward revisions of the Corporate Governance Code and the Stewardship Code. Naturally, as its important spirit, the Council aims at strengthening governance and sustainability, and increasing corporate value. We have been discussing the Code to achieve such objectives. And the Code is principles-based, and the 'Comply or Explain' approach is essential. The members expressed various views and important suggestions.

On the other hand, while approx. 2,200 companies are currently listed on the TSE First Section, most of them will migrate to the Prime Market next year. So, from the viewpoint of the Stock Exchange, Prime Market-listed companies should be required to pursue a higher level of governance in terms of the Code, its philosophy and principles, and comply with and implement such things.

Speaking from my own experience, I think there is room for companies to demonstrate their creativity and pursue a higher level of governance, depending on type of business and operation, so each company will be required to work on that, including the points I mentioned.

That's all.

[Kanda, Chair] Thank you very much.

Next, Ms. Takayama, please go ahead.

[Takayama, member] This is Takayama. I'd like to talk about governance standards required of Prime Market-listed companies.

There are several important items concerning governance standards, but I'd like to make comments on the independence of the board chair, and the lead independent director.

First, as for the independence of the board chair, it is desirable that an independent director assumes such a position in the future. Yet, I think it is still too early to require Prime Market-listed companies to do so. The board chair not only plays the role in facilitating board meetings, but also serves as the leader who guides important decision-making upon encouraging extensive discussions on the board. For that purpose, I believe that a director who understands the company well and is

capable of demonstrating leadership should assume the position of the board chair.

In order for an independent director to serve as the board chair, it is important to further enhance the ability of independent directors. Only after establishing a framework or system to enable it, companies should move to that stage, I mean the stage where an independent director assumes the position of the board chair.

In order to smoothly move to that stage, I believe it is necessary to appoint the lead independent director. This should be required of companies listed on other markets than the Prime Market. Supplementary Principle 4.8.2 of the current Governance Code stipulates that independent directors should endeavor to establish a framework for communicating with the management and for cooperating with *kansayaku* or the *kansayaku* board (Audit & Supervisory Board) by, for example, appointing the lead independent director from among themselves. Nonetheless, in reality, many companies have not yet appointed the lead independent director.

The lead independent director has important roles in summarizing and reporting opinions of independent directors to the board chair and executive management, thus contributing to deepening mutual understanding and communications; as well as serving as a contact point for dialogue with investors.

For your reference, let me share practices in other countries. In the UK, because it is required in the governance code, boards of most companies are chaired by independent directors. In the US, because there is no such requirement, currently, the percentage of the companies where boards are chaired by outside directors is approx. 30% of S&P500 companies, which are relatively large companies.

On the other hand, [in the US], the percentage of the companies appointing the lead independent director or the equivalent is approx. 70%.

It indicates that they have a system where the lead independent director fills a gap due to the fact that the board is chaired by an inside director.

Taking such overseas practices into account, I believe it is important to require the appointment of the lead independent director in Japan as well.

That's all.

[Kanda, Chair] Thank you very much.

Next, Mr. Kawakita, please go ahead.

[Kawakita, member] This is Kawakita. As many members already expressed their opinions, I'll briefly make comments on the roles of *kansayaku* or Audit Committee or the equivalent first. In this regard, I believe they should hold the power to direct the internal audit department and the power over personnel matters of the department. They need to instruct the internal audit department to take specific actions, if necessary. Naturally, the department should have dual reporting lines: a primary reporting line to *kansayaku* or Audit Committee, and a secondary reporting line to the president.

Staff members in the internal audit department are well-positioned to look at the entire picture of operations or business management through their jobs. In that sense, it is only natural to allocate an adequate number of people to the internal audit department, and high quality human resources should be allocated. By doing so, we can even expect that those who have work experience in the internal audit department will be promoted to the management layer in the future.

With respect to risk management, it is increasingly becoming important to ensure risk management for the purpose of increasing corporate value, as mentioned in the material. In this regard, while the risk management that puts a brake on certain corporate behavior is also important, companies too often decide not to take action, or even if someone proposes to do something, others reject it or point out possible problems with it. This may be because top managers of many companies in Japan were promoted from salaried employees.

Taking the digitalization for example, Japan has not been able to develop and provide innovative technologies. Japan falls behind other countries. I think the same can be said of the responses to COVID-19. In that sense, it is increasingly becoming important that such parties as the internal audit department, directors, and *kansayaku* monitor risks in failure to act.

Let me make another point concerning new market segments. I believe it is reasonable that the Prime Market requires stronger governance.

However, as other members argued, when we consider the requirements, it will be necessary to distinguish between those which should be included in the listing criteria as mandatory requirements and those against which companies can choose to 'Comply or Explain'.

Now I'd like to talk about parent-subsidary listings, which I already discussed before, focusing on the Prime Market. Speaking from the viewpoint of rational investors, it is not permissible that both a parent company and its subsidiary are listed on the Prime Market.

This point may, however, be a matter of the listing criteria, not a matter of the Code. With respect

to parent-subsidary listings, the Code should require parent companies to establish Nomination Committee and Remuneration Committee, both of which comprise a majority of outside directors. The parent companies need to disclose their management policies concerning their subsidiaries, specifically how they look ahead to the future relationship between themselves and the subsidiaries. Naturally, the Code should require the subsidiaries to appoint independent directors who constitute a majority.

That's all from me. Thank you.

[Kanda, Chair] Thank you very much.

Next, Dr. Ueda, please go ahead.

[Ueda, member] Thank you. I'll first make some comments on Material 1 about internal auditing and risk management.

I believe that internal audit is a very important issue, as other members mentioned. I heard from company officers in the UK that, when the governance reform started, the internal audit department was called watch dog, regarded as the place for fastidious and demanding people, and never liked by the management at that time. I feel the internal audit department in Japan has been following a similar path.

Under such circumstances, as another member mentioned earlier, I heard that some companies – trading companies – now recognize the internal audit department as a position for comprehending overall business operations, including risks, not as watch dog hated by people; and incorporate work experience in the internal audit department into a career path for promoting employees to the management layer. Such a way would lead to raising the awareness of the importance of the internal audit department, especially the awareness at the management layer.

In this connection, as for dual reporting, I believe the internal audit department should report to the board, etc. other than the CEO or president in relation to the important oversight function of the board, not limited to when the CEO caused a problem. Furthermore, as Mr. Okada pointed out earlier, each of *kansayaku* has very strong authority under *Dokunin* or individual independence system where each member can independently conduct and report on an audit. Especially, in the wake of a corporate scandal, I think this system will make a strong showing. Accordingly, I suggest that the Governance Code should facilitate the enhancement of the cooperation between the internal audit department and *kansayaku*.

In this light, I'd like to refer to risk management as well. When I read about and research the board functions in other countries, the term "risk appetite" frequently appears. It is about what risks the management is willing to take, and to what extent. I would say that the risk appetite is a framework for recognizing the scope of risks that the management should or can take in order to ensure growth-oriented governance and timely and decisive decision-making required by the Code. Especially, the scope of risks is becoming very complicated. For instance, sustainability issues are also becoming material risks for business management, and it is necessary to consider risks in the entire supply chain. So I suggest that the Code should emphasize such risk recognition as one of the board's functions.

Now I'll talk about the second subject concerning market segments. So far, our discussion has been centered around the globalization of the Prime Market. Now I think we need to consider the Growth Market as well. I do not mean that the Code should be applied to Growth Market-listed companies widely and in depth. When Growth Market-listed companies migrate into the Standard or Prime Market as a step-up in the future, the Governance Code will become very important, and also serve as guidelines for improving their internal structures. So I recommend that we should deliver a message to such companies at an early stage that the Governance Code keeps an eye on the Growth Market as well.

For instance, all listed companies are required to appoint outside directors. So sharing relevant issues, including their independence, would be useful for the development of start-ups in Japan in the future.

My last comment is about group governance. Group governance is an important issue not only for the Prime Market, but also for the Standard Market, from the perspective of protecting minority shareholders. Especially, in markets other than the Prime Market, I anticipate that discipline imposed by institutional investors will not really work. Therefore, if the Code includes discipline concerning group governance in the future, it should be ensured that this issue is recognized not only in Prime Market, but also in the Standard Market.

That's all. Thank you.

[Kanda, Chair] Thank you very much.

Next, Ms. Okina, please go ahead.

[Okina, member] This is Okina.

First, as for internal auditing, as other members mentioned, the reporting line to the board, *Kansayaku* board (Audit & Supervisory Board), or Audit Committee or the equivalent should be secured. In addition, the audit function should be enhanced in terms of both quality and quantity; and the top management should recognize the importance of audits, secure the independence of internal auditing, and ensure cooperation and information sharing. These are very important, so it is essential for the Code to describe these matters.

With respect to risk management, it is necessary to fully recognize the importance of group management accompanying the globalization, and the need for managing new risks accompanying digitalization, etc. from diverse viewpoints.

Second, a higher level of governance is expected of the Prime Market. For example, it is considered to require the establishment of Nomination Committee and Remuneration Committee, where outside directors play a central role and a substantively high level of governance is sought; and the disclosure in the English language. Today the members suggested various elements of the standards, and I generally agreed with them. However, as for the approach that the listing criteria stipulate certain requirements which companies must comply with, I think we need to consider various things before the application. As other members pointed out, companies do not have to comply with all principles of the Corporate Governance Code: if they cannot comply with certain principles, they can explain reasons for non-compliance. Rather, I believe it is very important that investors make qualitative judgements on the quality of governance of listed companies.

If the listing criteria for the Prime Market are set at a certain level, there will be no room for providing an explanation for non-compliance. We need to thoroughly consider the possibility that there may be cases not appropriate for being treated that way. It is important to check the requirements from that perspective. And it is also important to recognize and discuss the underlying idea of the listing criteria and the underlying idea of the Code.

I said that qualitative aspects are important. Let me share with you the discussion at the Expert Study Group on Capital Markets. In case of leaving some room for explanations [on non-compliance], it will be very important to address the implementation issue, specifically, who should judge the quality of such explanations. Basically, it is very difficult, and it should not be the stock exchange that makes such judgments. Essentially, it should be the market and investors who assess superiority or inferiority of governance, and that should be expected as a market practice which market

participants expect. These are what were discussed by the Expert Group.

In this light, I think it is very difficult to set such standards, but the listing criteria for the Prime Market needs to be considered. As mentioned earlier, it is important to check whether there is any problem in case of leaving no room to explain. And it is important [for the companies] to sincerely respond to the revised Corporate Governance Code, which contains higher standards, including explanation of non-compliance, and have dialogue [with investors] for the purpose of improving the quality of corporate governance in the future. I feel the continued need for sharing these points. This is my second point.

Finally, while our discussions in the past were summarized in the material, I also think these are the corporate governance issues that need to be discussed in the future. In particular, it was pointed out that it is very important for Japanese companies to address such issues as ensuring diversity and workstyles. I totally agree with the opinion. I believe it is very important to encourage boards to discuss such matters as well as to make disclosures. Probably this is related to ideal disclosure – how such matters should be disclosed in the Securities Report. If such disclosures are commonly made, the comparison of disclosures will become possible. Then they will be aware of the way many other companies disclose the matters. Then, in terms of behavioral economics, it may function effectively. In connection with the Governance Code, I hope active discussions will be held with a view to ensuring effective disclosures.

That's all.

[Kanda, Chair] Thank you very much.

Next, Mr. Iwama, please go ahead.

[Iwama, member] Thank you. As various opinions were already expressed, I'd like to just add what I'm thinking now.

One is about ensuring confidence in audits. I assume the basic policy [of the revision] is to enhance principles of audit, risk, and internal control in the Code. In the current Governance Code of Japan, these matters are written in "Section 4: Responsibilities of the Board" together with other matters. Instead, I suggest that an independent section should be created solely for audit, risk and internal control, and enhanced descriptions should be provided there.

With respect to ensuring confidence in audits, as other members mentioned, at least dual reporting lines should be imperative. In this light, we need to consider how to treat the case of Companies with

Kansayaku Board (Audit & Supervisory Board). Specifically, at present, *kansayaku* in Companies with *Kansayaku* Board assume a very strong role, but their power is limited in some aspects. So they tend to have only a single reporting line. If that is the case, I suggest that the Code should stipulate the introduction of dual reporting lines by adding a new direct reporting line to the lead outside director or the board chair who is an outside director.

As for the Prime Market, I generally agree with what other members mentioned. With respect to the electronic voting platform, we should consider that the use of such platform is somewhat mandatory for Prime Market-listed companies. I also suggest that we should consider earlier provision of disclosure documents for general shareholder meetings, which involves various matters.

In connection with ensuring confidence in audits, we should consider describing system risk and cyber security, which someone mentioned earlier, in the section of risk management.

As for other issues, I'd like to go into detail about defined contribution pension plans, as Mr. Kawakita pointed out in the last meeting. In the current Corporate Governance Code, Principle 2.6 refers to conflicts of interest in corporate pension funds. Separately from that, with respect to companies that have adopted a defined contribution pension plan, I recommend that the Code should refer to the presentation of an appropriate fund management program as well as thorough employee education, from the perspective of enhancing the well-being of employees. In connection with the social elements in ESG, looking at the reality of the defined contribution pension plans, their actual programs do not match long-term investment and long-term asset formation. The Code should urge corporate managers to address such an issue.

That's all from me.

[Kanda, Chair] Thank you very much.

Next, Mr. Takei, please go ahead.

[Takei, member] This is Takei.

First, I'd like to talk about dual reporting relationship between the internal audit department and officers in charge of audits. I also believe it is important. Some members referred to different organizational forms, but I don't think it is necessary to provide different descriptions for each of different organizational forms. The same description should apply, regardless of whether companies have adopted the form of Company with *Kansayaku* Board or other forms.

The legal investigation authority granted to officers in charge of audits, namely, *kansayaku*,

Supervisory Committee members, or Audit Committee members, is not unique to *kansayaku*. Such authority is common to Supervisory Committee members and Audit Committee members as well. Conversely, while there are only 5 or 6 officers in charge of audits in a company, it is impossible to investigate various matters without someone's support. Accordingly, such officers, including *kansayaku*, need to cooperate with the internal audit department. This is common to all the officers, regardless of whether they are *kansayaku*, Supervisory Committee members, or Audit Committee members. Since 2002 when the Commercial Code was revised, Japan Audit & Supervisory Board Members Association has called for cooperation with the internal audit department. Later, the revision of the Companies Act put a spotlight on it, so we have seen some progress in the cooperation. I recommend that the Code should describe the dual reporting relationship between the internal audit department and officers in charge of audits without differentiating explanations for each organizational form. This is my first point.

In this connection, I believe in the importance of the cooperation with the 2nd line of defense, which can obtain information earlier than the 3rd line, by which I mean the internal audit department, although there may be a different definition. On the 2nd line, it is especially important to enhance the legal function or the legal affairs department in terms of defense and risk-taking.

In Japan, the legal function is important from the perspective of risk management associated with global competition. As Professor Kawakita mentioned earlier, risk management in this context does not mean preventing various plans, but it means finding a solution and moving forward with healthy risk-taking. However, in many listed companies in Japan, such a legal function tends to be still weak. In this light, it is important to strengthen the function to promote healthy risk-taking, including not only the internal audit function on the 3rd line, but also the function of the 2nd line, for the purpose of increasing corporate value on a global level.

The Governance Code also refers to the board's function in risk-taking on the premise of growth-oriented governance. As Ms. Takayama mentioned earlier, agenda setting for board meetings is also important in terms of what agenda is set, and from what viewpoint it should be discussed. If a company wants to go for healthy risk-taking, it is very important for the legal function to help such board agenda setting. It is essential to strengthen the function of the 2nd line from that perspective as well.

These are the comments related to Material 1.

The next comment is about the Prime Market described in Material 2. I'd like to address an issue which other members did not refer to. According to the results of a recent survey of JPX400 companies, while we can see a significant increase in profit margin and ROE in the past several years, we can also see the trend of a significant decrease in R&D expenditure at the same time. There may be various views on the survey results, but various institutional investors will invest in Prime Market-listed companies, similarly to JPX400 companies. Various investors will participate in the market, and naturally there will be a significant number of short-term oriented institutional investors. Looking at the survey results, I feel that the companies to be listed on the Prime Market should be committed not to reduce such R&D investments as well as investments in intangible assets which we discussed previously.

In this light, the discussion on investments in intangible assets, which we had in the last meeting, is very important and should be incorporated into the Governance Code one way or another. In this connection, I believe that the Governance Code should refer to Sustainability Committee, which we discussed last time, as an illustrative example, if not a requirement.

It is really important to be poised to make company-wide efforts on material matters, including those from the perspective of human capital, intangible assets, and the supply chain; as well as to ensure the necessary allocation of management resources, including people, goods, and money. For that purpose, the current CSR committee is insufficient. There is a need to transform CSR committee to a new internal committee with greater significance including the top management or a Vice President-level executive. Only after establishing the committee by ensuring the visibility, which is the term Mr. Oba used, company-wide, cross-functional discussion will happen, and management resources will be allocated as necessary.

In the Prime Market, there will be various kinds of short-term oriented noises. In a sense that companies should externally demonstrate their significant commitment to work on their own sustainability, it is important that the Code refers to Sustainability Committee under the 'Comply or Explain' approach. Even merely referring it as an example is fine.

The third point is about digital transformation (DX) in connection with Material 2 as well as the sustainability which I just mentioned. I believe governance associated with DX is a part of sustainability governance. The digitalization or DX will make various things more convenient, introduce new capabilities, and increase the efficiency. At the same time, companies will face new

social issues as well as the need for coordinating the various conflicting interests. Accordingly, I believe it is important for listed companies to work on new digital issues in a forward-looking manner, as a part of their sustainability initiatives. This is my third point.

The fourth point is a general issue. I believe that the Governance Code should maintain the 'Comply or Explain' approach. It would be acceptable that certain matters are based on 'Comply and Explain'. Nonetheless, even in the Prime Market, I don't think it is proper to define certain matters as mandatory compliance requirements. As Ms. Okina mentioned earlier, it is important to thoroughly examine the quality of explanations, and take necessary actions accordingly. I believe we should be cautious about imposing mandatory compliance requirements.

Professor Ikeo used to say that the Governance Code is a Sunshine policy, not a North Wind policy. To ensure growth-oriented governance, the starting point of the Governance Code is not excessively restricting voluntary efforts of companies, so we should stick to this starting point and maintain 'Comply or Explain' approach. I believe we should sort out the matters without requiring mandatory compliance.

That's all.

[Kanda, Chair] Thank you very much.

All participating members have expressed their views. We still have a little time until the scheduled closing time. If any of you would like to ask questions or make additional comments, please let me know.

Nothing in particular? Then although it is earlier than the scheduled closing time, I'd like to close the discussion session.

Thank you very much for your invaluable comments and suggestions. This discussion was the last in a series of discussions on individual issues.

Accordingly, based on your opinions expressed so far, I'd like you to discuss a draft of the revised Corporate Governance Code [to be prepared by the Secretariat] next time.

Now I'd like the Secretariat to make an administrative announcement, if any.

[Shimazaki, Director of the Corporate Accounting and Disclosure Division, FSA] Thank you very much for your participation today. As for the next meeting date of the Follow-up Council, we will fix the date, which is convenient for you, and let you know later.

That's all from the Secretariat.

[Kanda, Chair] Thank you very much.

Now I declare the meeting adjourned. Thank you for your participation.

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