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

October 31, 2014
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1. Role and functions of board (supplementary notes to the fourth Council of Experts)

As stated in the United Kingdom's Corporate Governance Code, a code is something which indicates shared basic principles for outstanding governance - in other words, best practices embodying high standards. Further, it requires companies to either implement such practices, or to provide an explanation of other means by which they are achieving better governance and consistently boosting corporate value ('Comply or Explain').

Therefore, **as long as an explanation is provided, the code serves as a malleable set of rules, where the freedom of individual companies is set as a major premise. This makes it all the more necessary for us in Japan to ensure that our own Code points to high-standard best practices in corporate governance.**

Incidentally, at the fourth Council of Experts, some have pointed out that a monitoring- (overseeing-) type board of directors may not fit all, while others have remarked that it may be problematic to regard it as a best practice given that, within the structure prescribed by the current Companies Act, board of a Company with *Kansayaku* board is a management- (executive-) type one.

To begin with, it is obvious that, at a Company with *Kansayaku* Board, the board is not expected to function exclusively as a monitoring body. On the other hand, in view of the fact that the board has the authority to appoint and dismiss representative directors, and of the nature of recent amendments to the Companies Act in relation to outside directors, it is also clearly not the case that the board is to serve only as a management function while the monitoring function is performed exclusively by the *kansayaku* board.

As other members have pointed out during previous discussions, Companies with *Kansayaku* board **adopt a hybrid type of board of directors, combining management- and monitoring. A natural, easy-to-understand interpretation of this is that the board of directors mainly serves a 'offensive' role in the context of monitoring, while the *kansayaku* board serves a 'defensive' one.** Accordingly, **the essential point at issue in drafting the Code will be how to balance the monitoring**

element and the management element in a hybrid-type board of directors. In other countries, this point is regarded as holding the key to improving corporate governance in Japan.

Note that, in this context, **'offensive' means a company's efforts to accurately and consistently grasp upside business opportunities to make a profit, while 'defensive' means efforts to minimize downside risks. It is therefore natural for the *kansayaku* board to deal with matters in relation to downside risks. At the same time, a *kansayaku* who has relevant knowledge should be allowed to express their opinion on how upside opportunities are managed and this should not be prevented either.**

In our discussion of the Code, as is evident from the Comply or Explain concept, we are not looking for a one-size-fits-all solution; rather, we are simply attempting to establish a standard model that is acceptable as a best practice to investors and stakeholders both in Japan and abroad.

In this respect, a board of directors with a focus on the management element entails a conflict of interest, as executives also serve as supervisors. Consequently, such a model for a board is not supported as being best practice by Japanese or overseas investors and stakeholders.

Moreover, **while many Japanese companies have adopted a board of directors that focuses on the management element, they have failed to maintain earning power, potential for growth and employment capacity over the very long term, greatly diminishing their international standing (see the attachment).** In view of such a decline in the standing of Japanese companies, it is clear that the conventional corporate governance styles, focusing on the management element of board, has failed to bear fruit. It is worth repeating that, **for this very reason, a reform of corporate governance in a new, 'offensive' direction was one of the central themes indicated in this year's revision of the Japan Revitalization Strategy.**

On the other hand, **investors and other stakeholders highly value models of the board focusing on the monitoring element (not limited to Companies with Three Committees, but also hybrid-type practices at Companies with *Kansayaku* Board where the maximum possible separation between the execution of business and supervision is achieved). This is a global trend, and clearly this the best practice that Japan should aim for.**

Undeniably, some companies may be best suited to a board of directors model focusing on the management element. Such companies should address the issue directly, presenting logical and specific reasons under the Comply or Explain rule. **Some have pointed to the difficulty of 'explaining'. However, if a top executive of a listed company truly**

cannot publicly give an explanation of a policy as basic as that for the company's corporate governance, this would indeed be sufficient grounds to doubt his/her qualifications as a top executive.

2. Responsibilities of board, etc. (composition, institutional design and procedures, etc.)

(1) Role of independent directors

- As stated above, the board of directors should be responsible for ‘offensive governance’, while the *kansayaku* board should be responsible for ‘defensive governance’. Accordingly, independent directors who sit on the board should mainly serve to implement ‘offensive governance’, boosting the company's earning power and potential for sustainable growth. The key to offensive governance lies in the exercise of authority over personnel matters (specifically, determining appointments, dismissals and remuneration). Also, the board should monitor whether the entire management system is functioning soundly toward boosting corporate value in a sustainable fashion. Additionally, I should point out that the board is not required to assess the detailed specifics of individual business decisions.

Therefore, **the main role of independent directors lies in supervising management through important decisions by the board, such as the appointment/dismissal of members of management, evaluation of the management system as a whole, etc., with the aim of securing the social utility and long-term value creation of listed companies.** Of course, independent directors are also expected to provide advice geared to boosting management efficiency, look out for any conflicts of interest, and take into account the opinions of shareholders and other parties.

(2) Requirements and qualifications of independent directors

- Given that independent directors will lack in-depth knowledge of the company and related industries, some have pointed out that they should not be expected to fulfill the above roles.

Provided, however, **that the company gives appropriate support,** the type of supervision of management that is expected of independent directors, as outlined above, **should be feasible for someone who is experienced in running and managing organizations and has a sense of social norms. There should be no need to appoint someone from inside the company or thoroughly familiar with related industries.** Conversely, only independent directors are capable of saying what they think without letting themselves be held back by norms and obligations ties existing at the company or in the industry.

Nevertheless, it is the independent directors' duty to build on their knowledge of the company and of the industry.

(3) Independence criteria

- Be it in the ‘offensive’ or the ‘defensive’ direction, securing independence is an important necessity for representatives and other members of management alike. This is because the board must be independent from representatives and other members of management in order to prevent misconduct by representatives and other members of management in the ‘defensive’ sense of governance, and in order to prevent the postponement of choices that are unfavorable to members of management in the ‘offensive’ sense of governance (for example, the avoidance of choices that would be disadvantageous for the home division of a particular member of management).

In view of the scarcity of personnel capable of serving as corporate managers in Japan, there is an undeniable possibility that excessively demanding criteria for independence may cause a supply shortage for personnel who can serve as independent directors. On this point, I believe that the independence criteria stipulated by the Tokyo Stock Exchange give a certain amount of consideration to personnel supply, by, for example leaving it to companies to determine what qualifies as a ‘main client’. In order to truly improve corporate governance, the actual level of candidates for the independent director positions should be given more weight. **Instead of immediately setting a more precise formal criteria, we should instead leave individual companies the flexibility to make decisions based on individual circumstances.**

Having said this, companies need to ensure transparency by disclosing a rational criteria for determining independence, as well as information on the independence of each director. The appropriate disclosure of information will allow shareholders to exercise their voting rights in a meaningful manner when officers are being appointed, thus putting governance into practice. In other words, shareholders must carefully examine the information disclosed by companies and exercise their voting rights responsibly.

(4) Diversity in board

- As I have stated in my previous opinion paper, the boards of directors and top management at Japanese companies tend to have a homogeneous composition due to the seniority and lifetime employment systems that distinguish Japanese-style management.

Therefore, securing diversity in the composition of board and top management is an important management task that Japanese companies need to focus on.

At present, the small ratio occupied by women is at the center of attention; however, at Japanese companies the path to securing diversity is also being obstructed by the large number of internal promotions, with the majority of top management lacking experience at other companies, and few are from other nationalities (see attachment).

Accordingly, in order to break through such obstacles and recover their earning power, Japanese companies need to secure diversity in their boards of directors in terms of gender, age, nationality, technical skills and employment history.

(5) Suitable scale for board

- In order to boost the quality and speed of discussions at boards of directors, the number of directors on the board should be limited. In particular, Japan's larger companies generally have poor employment mobility due to the lifetime employment system. This has resulted in a trend to reward employees who have contributed to the company over the years, causing a risk for boards of directors to become larger than necessary.

In view of the central function served by board in exercising authority over personnel matters and evaluating the management system as a whole, limiting the number of its members should not be an issue; rather, it would make it easier for the Board to reach consensus and fulfill its role.

Accordingly, **we should set the appropriate scale of board to ten members.** On the other hand, the number of executives appointed should be commensurate to the influential characteristics such as scale and nature of the company's business. Also, I believe that in Japan there is an incorrect perception that directors enjoy a higher status compared to executive officers. In reality, there is no hierarchy; this is simply a difference in roles, and in fact it may be natural for an executive officer to receive higher remuneration. The Corporate Governance Code should include this point in order to dispel any erroneous notions.

(6) Number, etc. of independent directors

- **In view of the distinctive tendency of Japanese workers (especially corporate employees) to succumb to peer pressure, it will be necessary to establish necessary conditions for independent directors to provide honest, straightforward opinions.**

Therefore, the nomination advisory committee and compensation advisory committee, discussed below, should be composed mainly of independent directors. In addition, **in order to implement the appropriate conditions for the board itself, one third or more of the Board's members should be**

independent outside directors.

(7) Other points to note concerning the composition of board

- In order to ensure separation between the execution of operations and supervision, internally promoted directors should not serve concurrently as executive officers; directors serving concurrently as executive officers should be limited to half at most.

Also, at Japanese companies there are numerous cases where the president retires to serve as board chairman but effectively retains authority over business. For this reason, there is a risk of decision-making with a lack of transparency occurring behind closed doors, and an uncertainty over who holds authority and responsibility. Therefore, the Code should stipulate for companies electing a chairman to explicitly state his/her authority and responsibility.

3. Operation, committees, training, etc.

As discussed above, it will be important to create the necessary conditions for independent directors to voice objective opinions. To this end, the Board's chairman should not serve concurrently as an executive officer.

Moreover, in the exercise of authority over personnel matters - an important point in ‘offensive governance’ - it will be particularly necessary to guarantee objectivity. Therefore, **even Companies with *Kansayaku* board and Companies with Audit and Supervisory Committee should set up a nomination advisory committee and a compensation advisory committee, composed by a majority of independent outside directors.** Also, independent directors should serve as the chairmen of the nomination advisory committee and the compensation advisory committee.

Unlike in the case of Companies with Committees, the nomination advisory committee and the compensation advisory committee are established on a voluntary basis; however, should the board make a decision that goes against the committees' opinion, the Code should stipulate for the Board to provide sufficient information to the shareholders and other stakeholders, and fully explain the rationale behind this decision.

On the other hand, voluntarily setting up an independent committee deliberating and providing advice on corporate governance may also prove to be an effective means of bolstering the latter. In such cases, independent directors and independent *kansayaku* would be good options to becoming members of the committee.

4. Other matters (holding company governance)

In recent years, cases of misconduct have been occurring at enterprises affiliated to holding companies. I believe that one reason for this lies in the failure of holding companies to enforce governance at their business companies. At corporate groups adopting the holding system, the most dominant business company will exert its clout, sometimes giving rise to the suspicion that authority over personnel matters is effectively left to that business company.

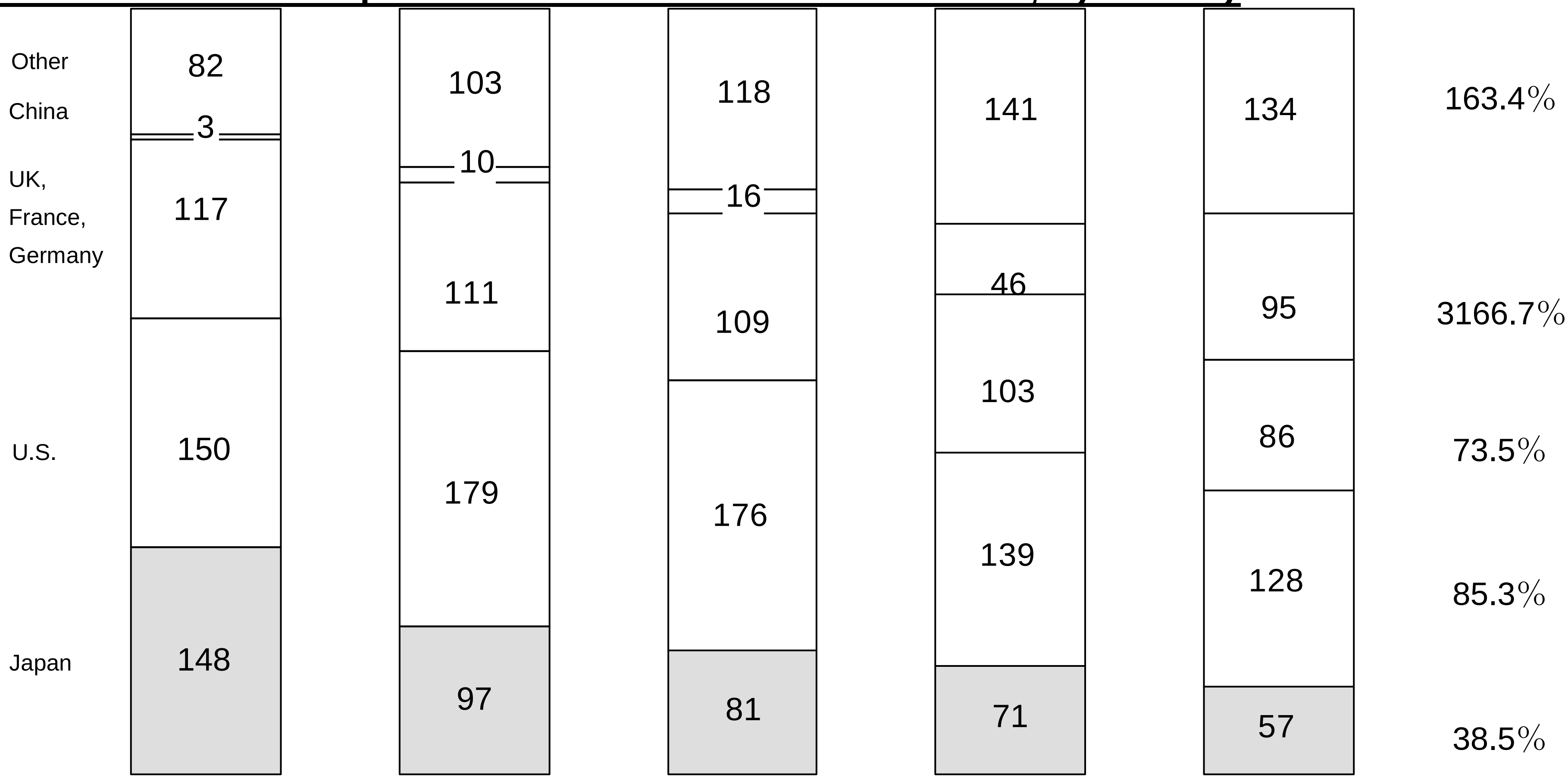
The number of holding companies is rising year after year. In the future, we will need to consider how to prevent the adoption of the holding system from depriving governance of its substance. Accordingly, in the process of revising the Corporate Governance Code, we should indicate that this issue is to be reviewed as well.

Attachments

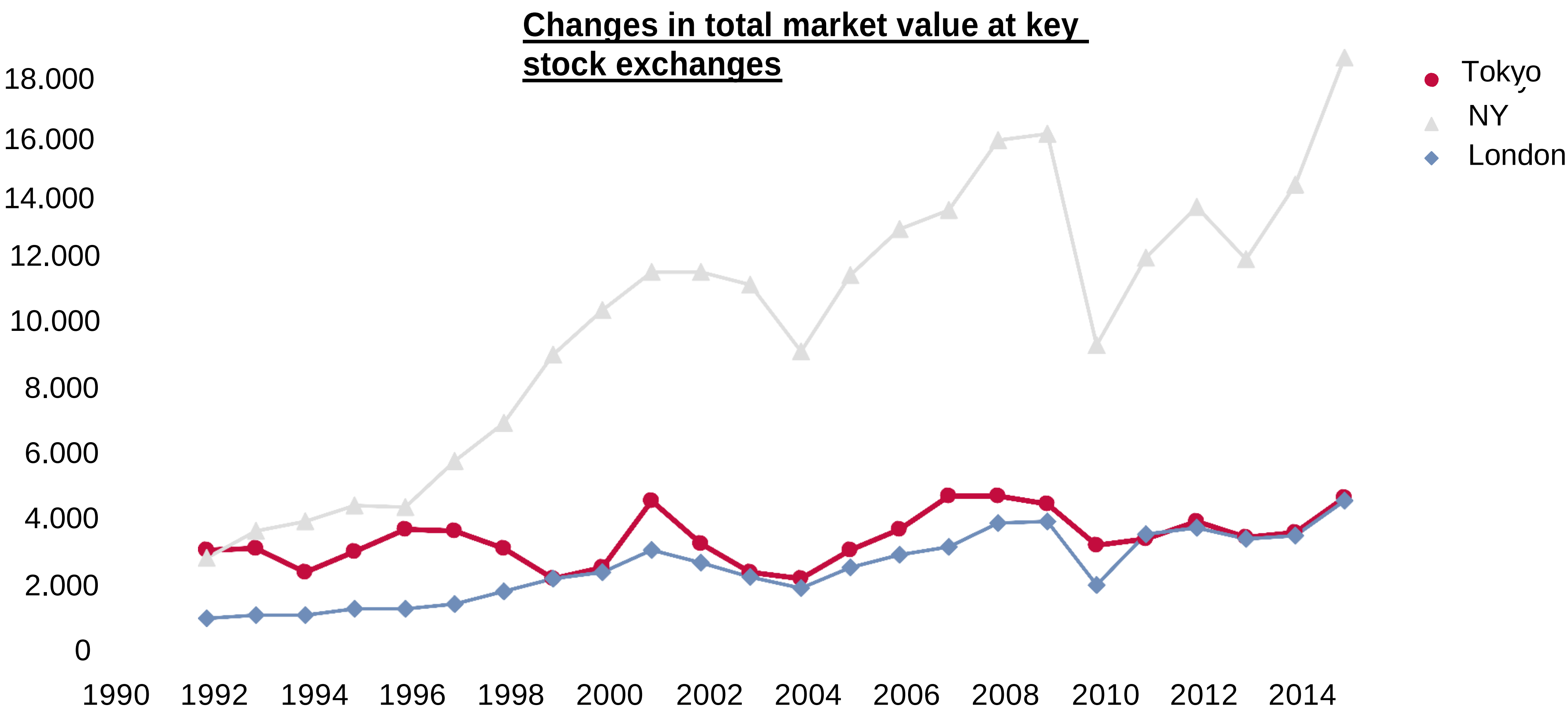
I G P I

◆ The number of Japanese companies ranked in the Fortune Global 500 has dropped dramatically (now 38.5% vs. 1995).

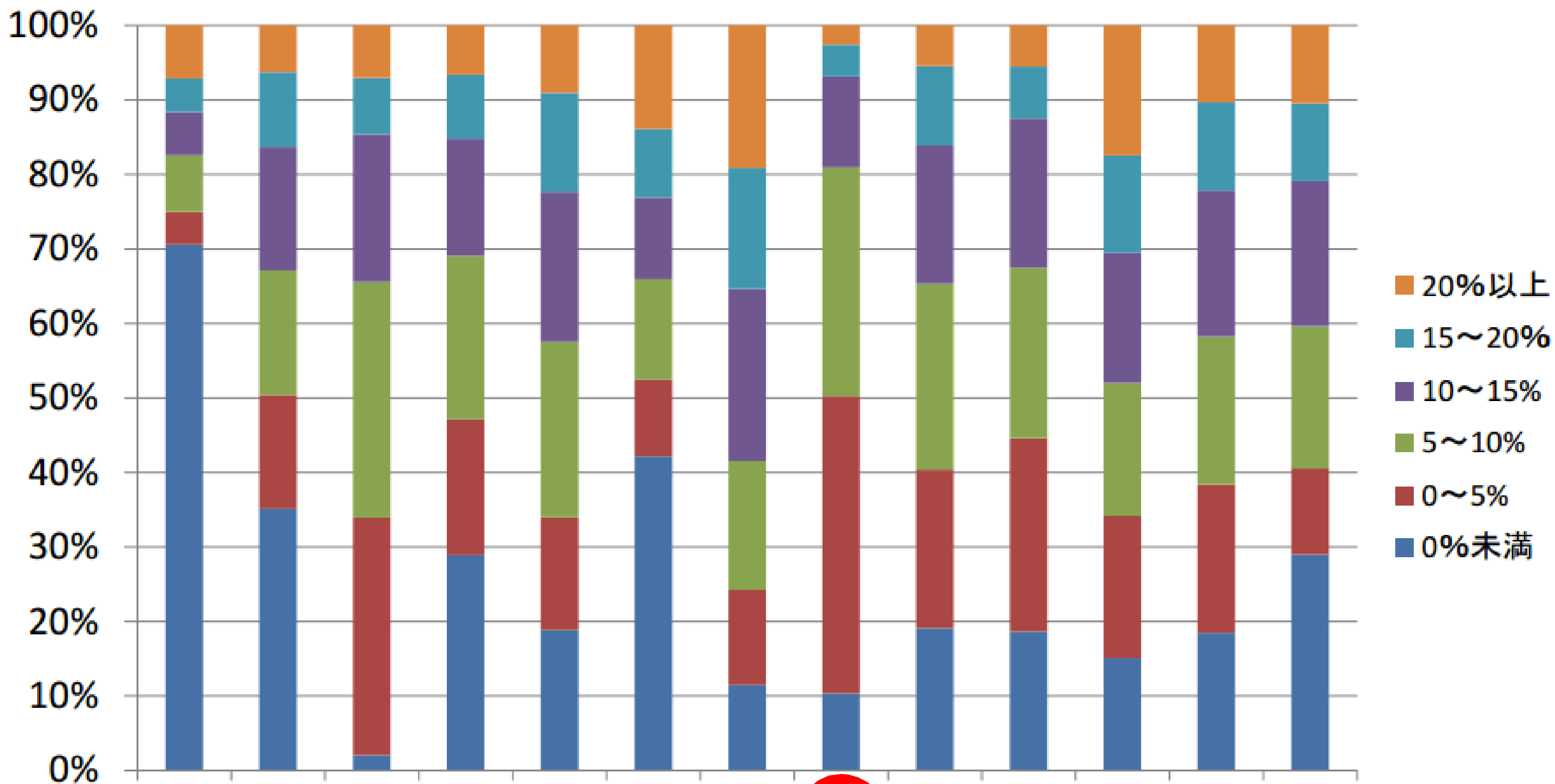
Composition of the Fortune Global 500 list, by country



◆ A comparison of total market value between 1990 and 2013 shows sluggish growth in Japan only, with a 667% increase at the New York Stock Exchange and 521% at the London Stock Exchange, but only 155% at the Tokyo Stock Exchange.



◆ ROE at Japanese companies is low, with only a small part of business at 10% or more.



	AUS	CAN	CHN	DEU	FRA	GBR	IND	JPN	KOR	MYS	SGP	TWN	USA
中央値	-11.28	4.77	7.13	5.94	8.40	3.77	12.05	4.97	6.99	6.18	9.41	7.63	7.72
標準偏差	67.92	43.33	13.03	39.28	25.15	964.11	17.19	10.38	16.77	12.45	30.14	14.94	158.25

Source: "Significance and Role of Corporate Governance Disclosure", by Tetsuyuki Kagaya, Hitotsubashi University

* Each company's median value for the past ten years was calculated based on each company's data for 2000-2010, from the Compustat Global database. The chart shows the distribution of median values for each company.

◆ A comparison of Japan, the U.S. and Europe employing DuPont ROE analysis suggests that low ROE at Japanese companies may be the result of low profit ratios.

$$\frac{\text{Current net profit}}{\text{Shareholder's equity}} = \frac{\text{Current net profit}}{\text{Net sales}} \times \frac{\text{Net sales}}{\text{Total assets}} \times \frac{\text{Total assets}}{\text{Shareholder's equity}}$$

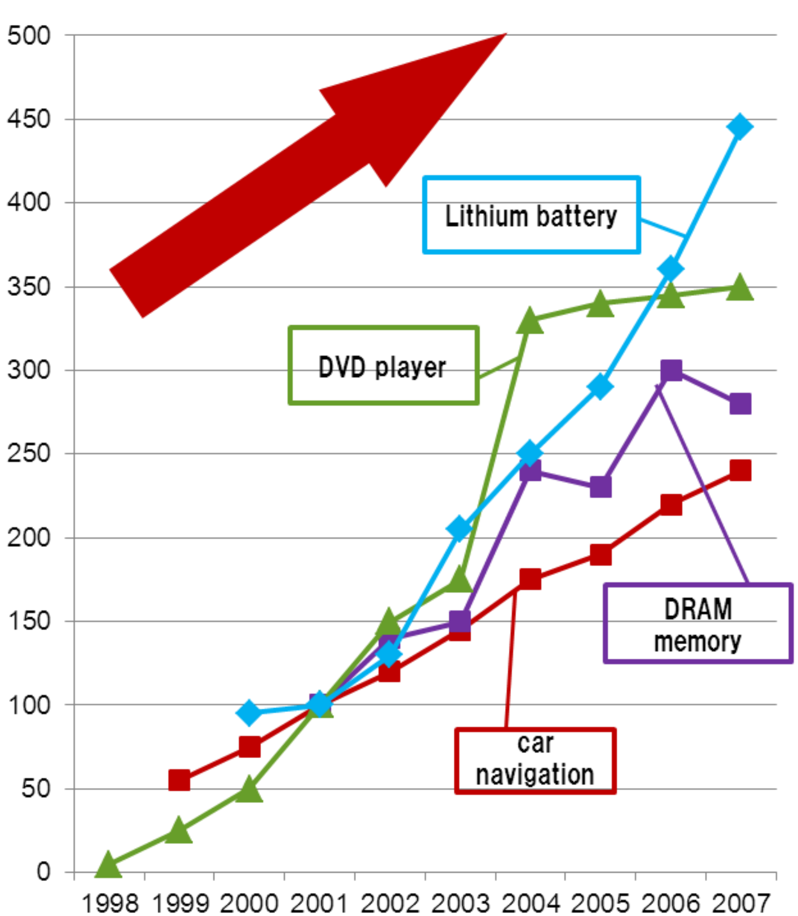
		ROE	Net profit ratio on sales	Turnover rate of total assets	Financial leverage
Japan	Manufacturing	4.6%	3.7%	0.92	2.32
	Other industries	6.3%	4.0%	1.01	2.80
	Total	5.3%	3.8%	0.96	2.51
United States	Manufacturing	28.9%	11.6%	0.86	2.47
	Other industries	17.6%	9.7%	1.03	2.88
	Total	22.6%	10.5%	0.96	2.69
Europe	Manufacturing	15.2%	9.2%	0.80	2.58
	Other industries	14.8%	8.6%	0.93	3.08
	Total	15.0%	8.9%	0.87	2.86

Source: "Competitiveness and Incentives Toward Sustainable Growth – Desirable Relationships between Companies and Investors" project (Ito report)(analysis by Misaki Capital Inc. (Bloomberg data analyzed based on initial analysis by Merrill Lynch's Mr. Kamiyama)

Note 1: based on full-year business results for 2-12; excluding finance and real estate

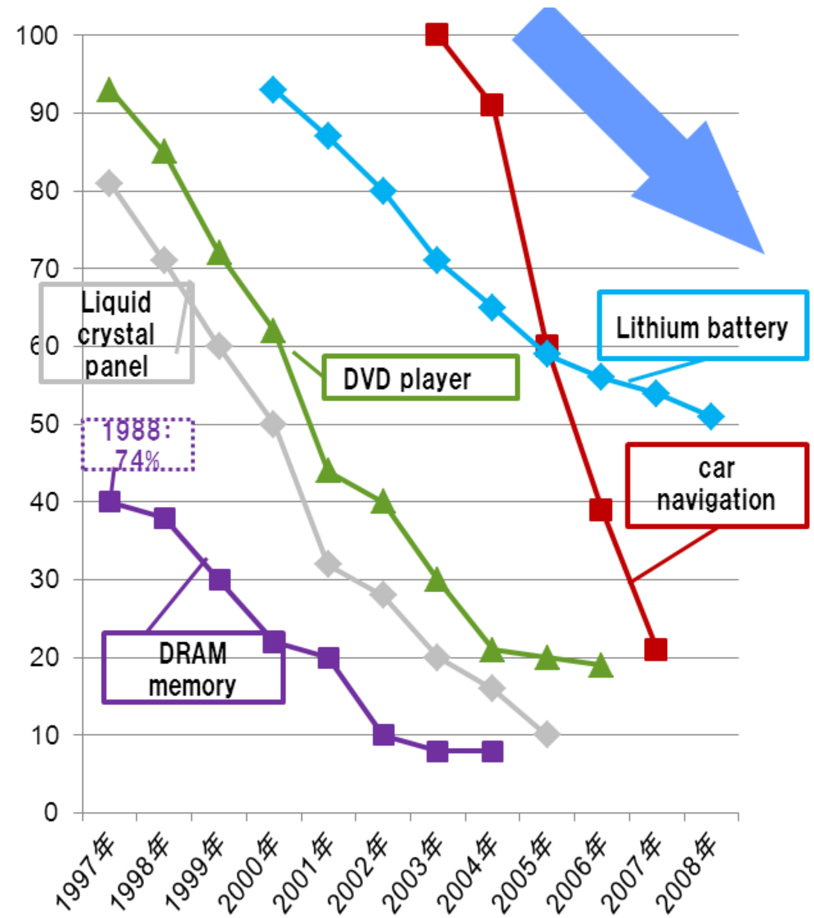
Note 2: target = companies from which the necessary data was successfully acquired among TOPIX 500, Bloomberg European 500 Index target companies

Gradually growing world economy



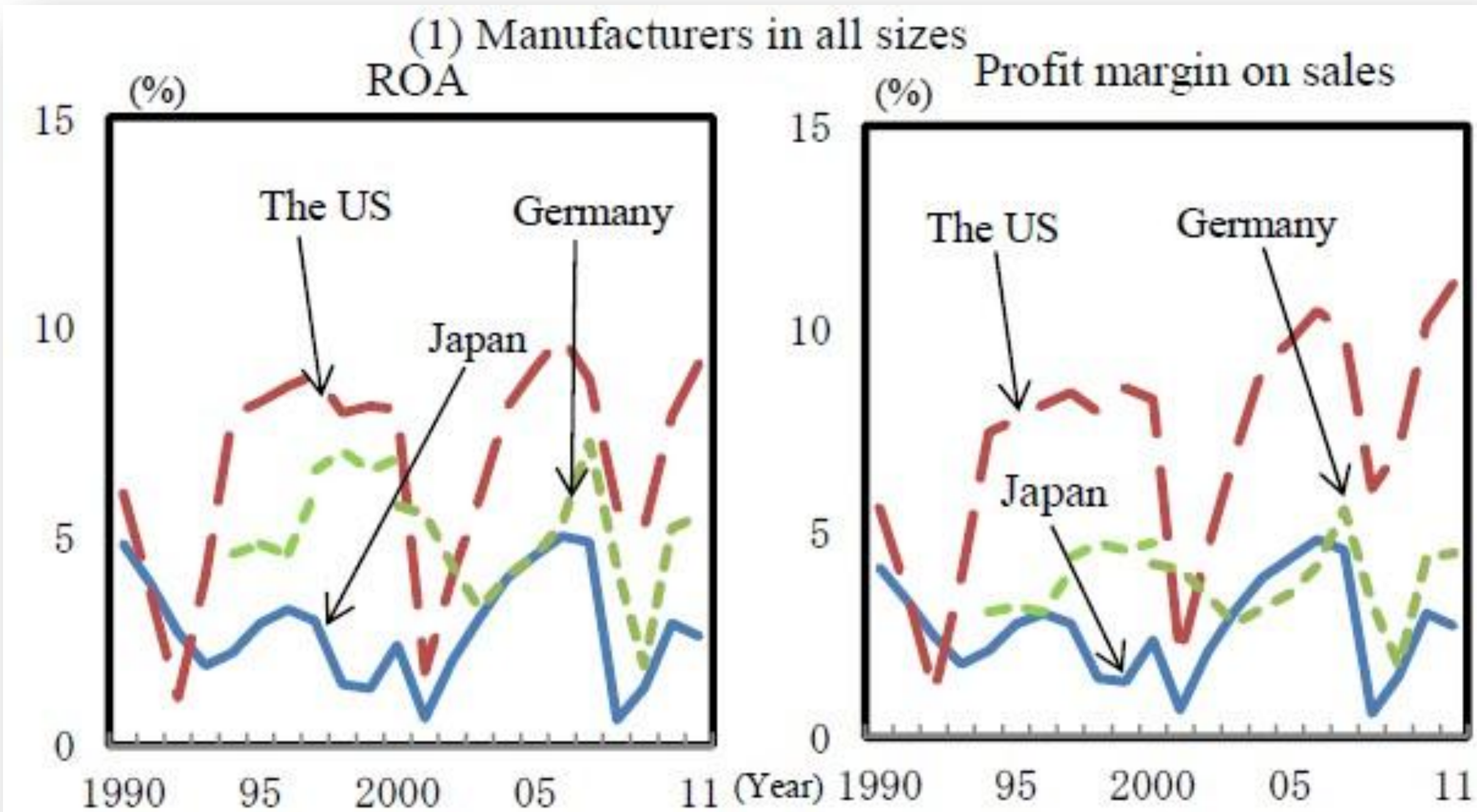
（100 based on 2001）

Decline in the market share of Japanese companies



（Source）Industrial Structure Council, Industrial Competitiveness Committee （extract from METI 2010

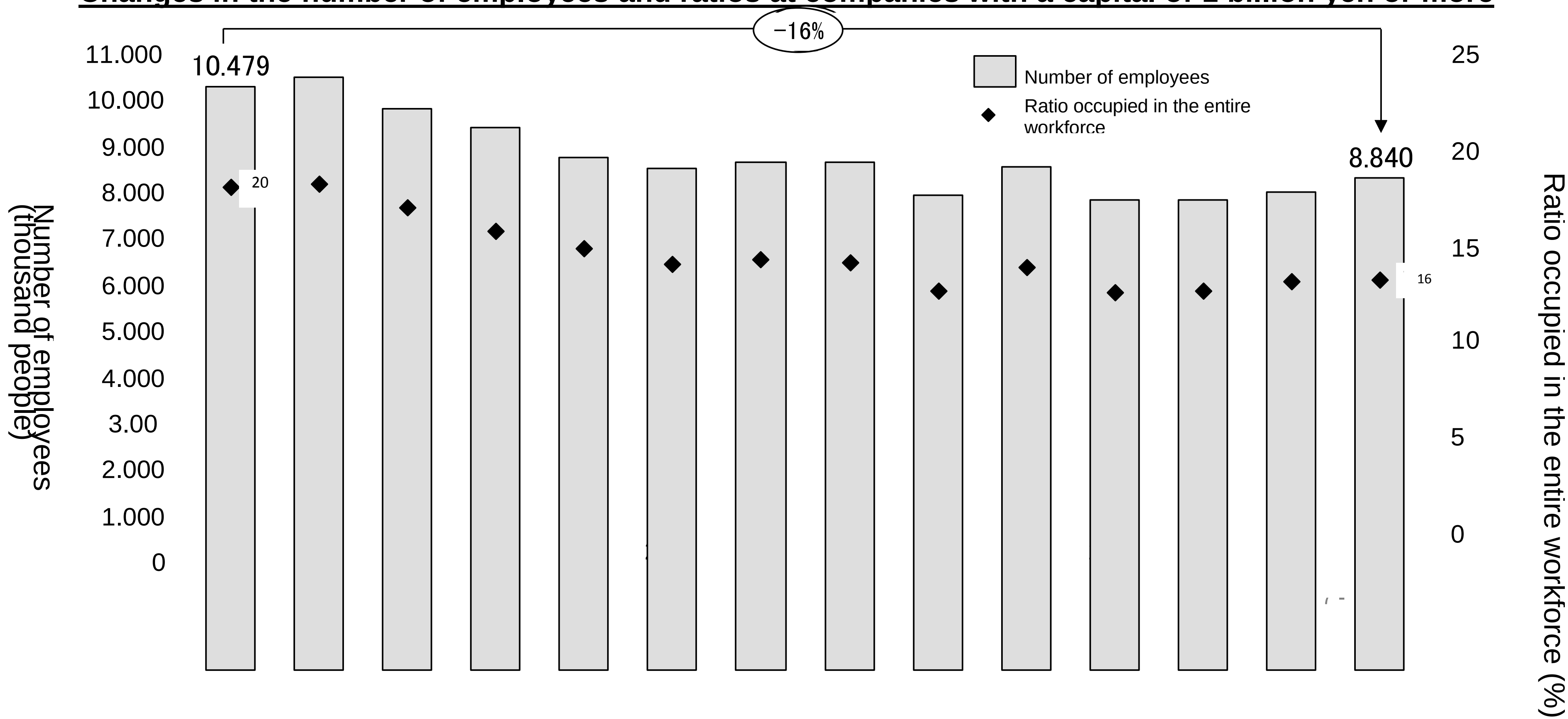
Changes in ROA and profit margin on sales in the manufacturing industry



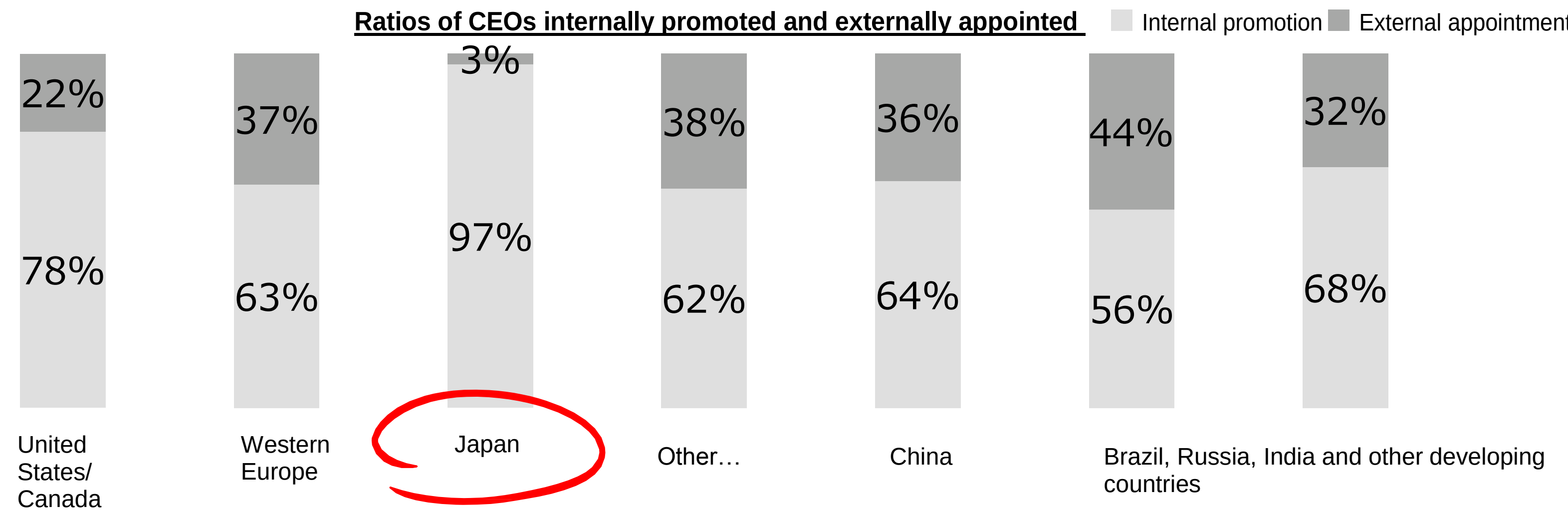
Source: Annual Report on the Japanese Economy and Public Finance 2013

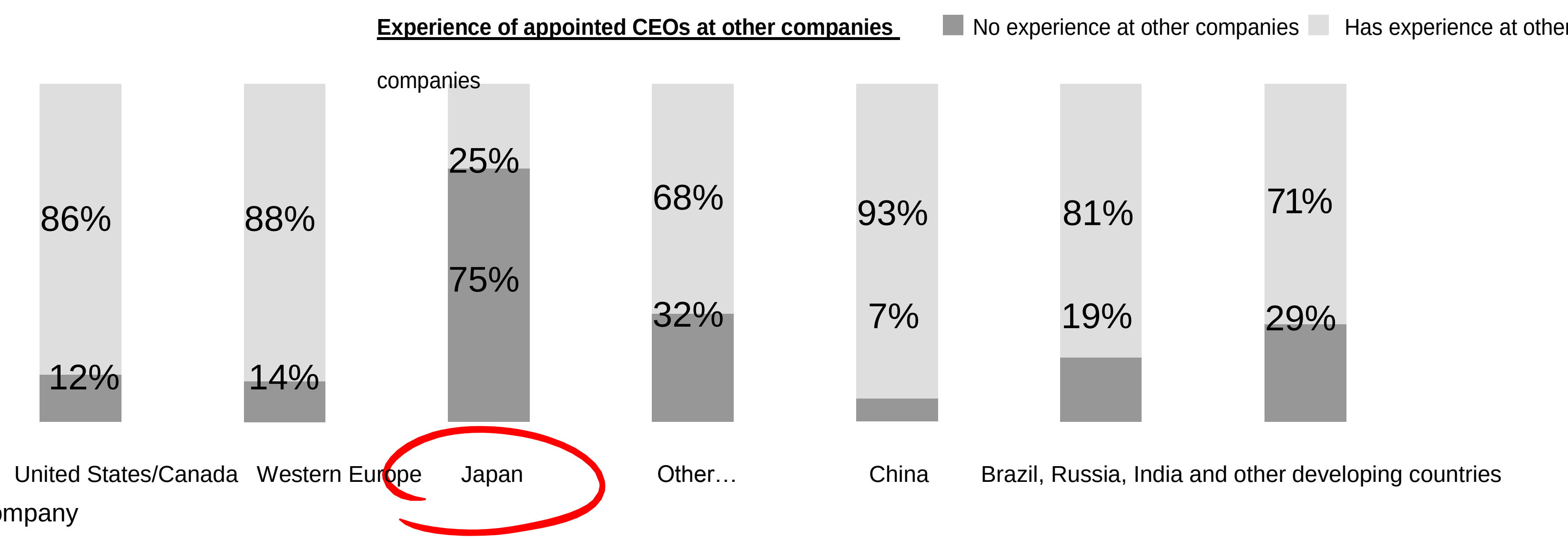
◆ The workforces of companies with a capital of 1 billion yen or more (many of which are listed companies) have decreased dramatically since 2000, and the ratio of the entire workforce they account for has also greatly decreased.

Changes in the number of employees and ratios at companies with a capital of 1 billion yen or more

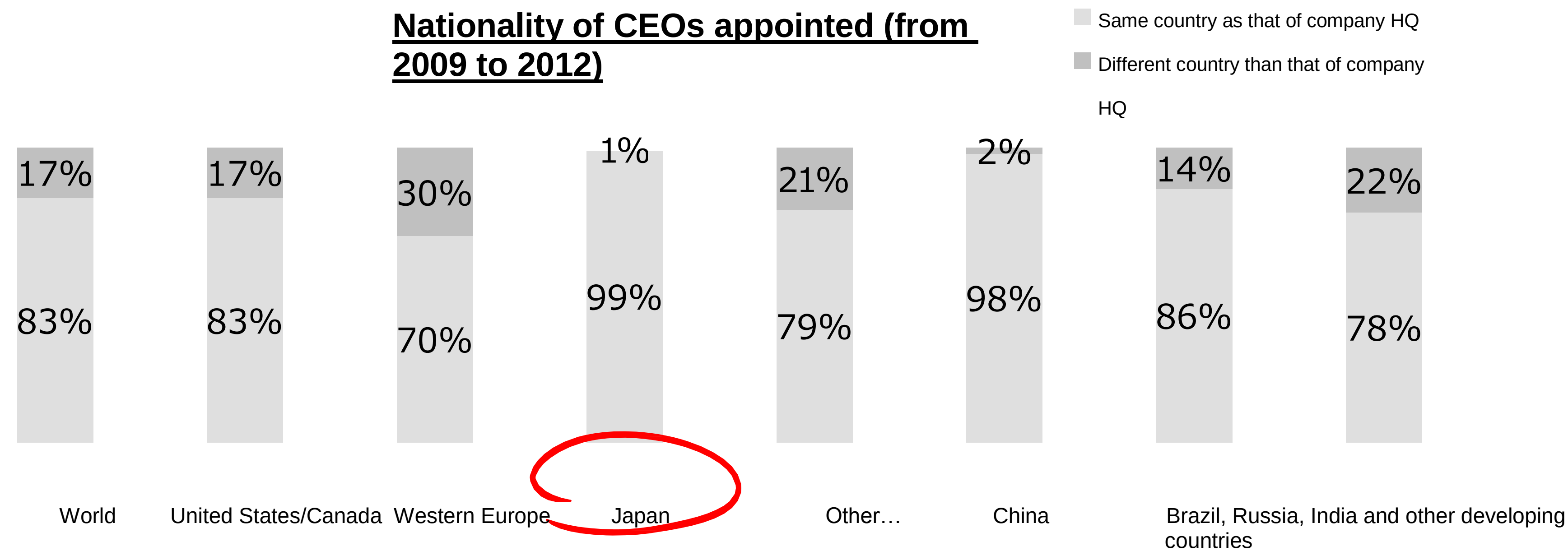


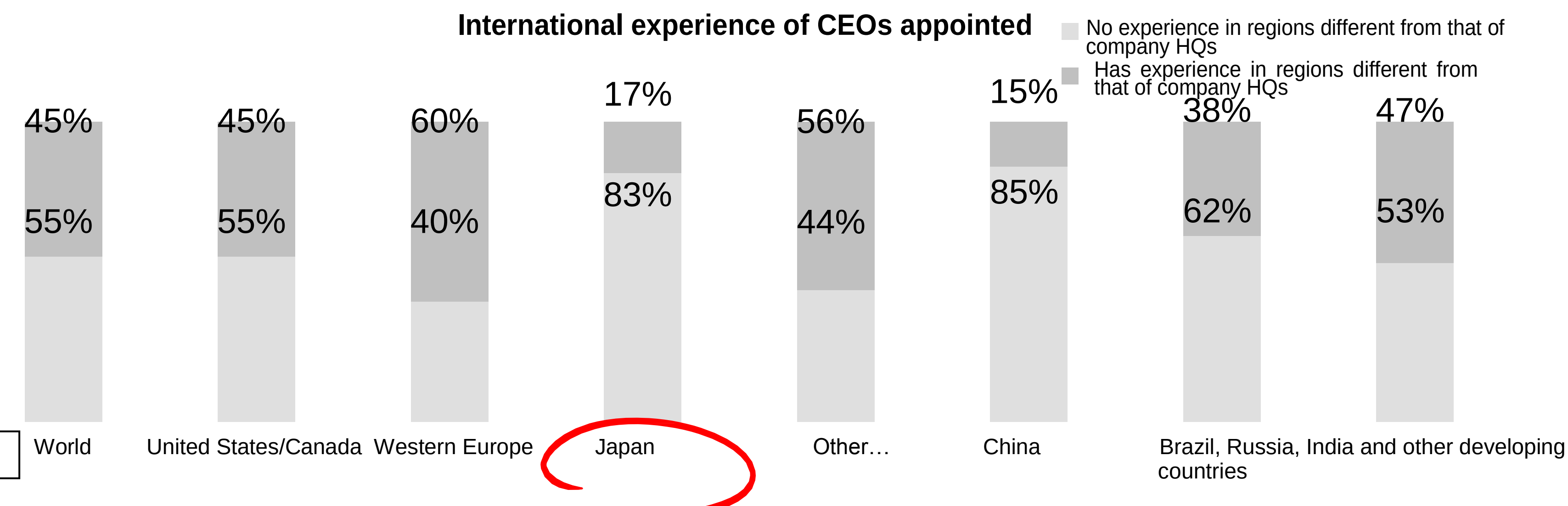
Source: "Results of the Statistical Survey on Private Wages" by the National Tax Agency





Source: Booz & Company





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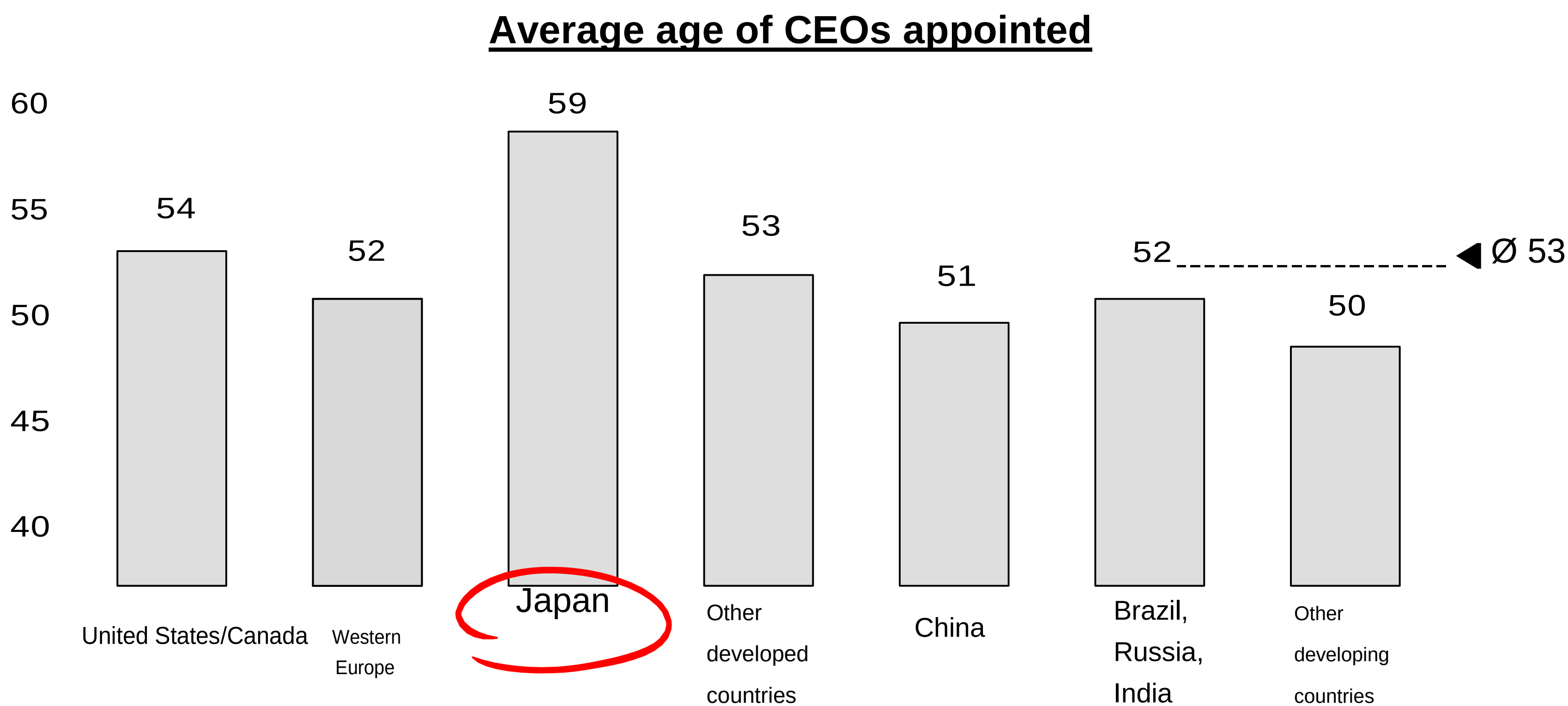

Source: Booz & Company