A Handbook on Practical Issues for Independent Directors/Auditors

Supervised By Hideki Kanda
Written And Edited By Tokyo Stock Exchange, Inc.

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Notes from Supervisor

Tokyo Stock Exchange introduced rules relating to Independent Directors/Auditors ("Independent Director/Auditor System") in December 2009. This System requires a listed company to secure among its outside directors/auditors one or more person who is unlikely to have conflicts of interest with general shareholders, and to notify Tokyo Stock Exchange of their appointment as Independent Director(s)/Auditor(s). Thereafter, this System was partially revised in May this year.

Considering various events which recently occurred in the securities market and opinions from investors in Japan and around the world, I believe that the expectations of Independent Directors/Auditors within listed companies and importance of their role are increasing more than ever. Meanwhile, we are hearing more opinions regarding what Independent Directors/Auditors should actually do.

Given these circumstances, TSE has prepared this book to explain to Independent Directors/Auditors their expected roles, and what matters should be considered and what actions are expected when decisions of a listed company are actually made, together with the ways of thinking behind such actions.

I hope the contents of this book will be shared by Independent Directors/Auditors and that this book will thereby contribute to securing the soundness and prosperity of Japanese listed companies and encourage further development of the securities market, corporate environment, and economy of Japan.

October 2012

Hideki Kanda
Professor of the University of Tokyo

Preface

At every listed company, there are many general shareholders whose holding ratios are low and who may not have significant effects on the company's management, and these shareholders change day-to-day through market transactions. Listed companies enjoy a variety of benefits from the liquidity such general shareholders provide to the market. However, the interests of such general shareholders are likely to be overlooked by the management of listed companies.

We note, however, general shareholders are special among the various stakeholders of a listed company in that they only may obtain benefits from enhancements in corporate value. It is essential and necessary for a listed company to pay full attention to the interests of general shareholders in its operation.

Under its listing rules, Tokyo Stock Exchange ("TSE") requires listed companies to secure one or more outside director/auditor who is unlikely to have conflicts of interest with general shareholders, called an "Independent Director/Auditor," as a corporate governance measure that all listed company should have in consideration of the significance of protecting the interests of general shareholders. However, in order to increase the effectiveness of the Independent Director/Auditor System, and to fulfill its purpose of protecting the interests of general shareholders, Independent Directors/Auditors must involve themselves in the actual decision making process of listed companies.

This handbook was published as a measure to enhance effectiveness of Independent Director/Auditor System with the aim of providing an opportunity for Independent Directors/Auditors to better understand their expected role and explaining what matters should be considered when fulfilling such roles, alongside the reasoning behind these matters.

This book is composed of a "General Discussion" section and an "Itemized Discussion" section. In the General Discussion section, we explain the position of Independent Directors/Auditors and basic viewpoints. In the Itemized Discussion section, we show the viewpoints of general shareholders and a checklist for each agenda item to be resolved by the board of directors, and provide explanations for each case.

Please note, however, that actual duties of Independent Directors/Auditors vary depending on the division of responsibilities with other directors/auditors, the listed company's scale and business conditions , and whether such individual is serving as an outside director or outside corporate auditor[1]. This means that even in given identical circumstances, there are various approaches which may be taken to fulfill an independent director/auditor's duties. Therefore, we

[1] In this book, the term "corporate auditor" is used as English translation for "Kansayaku," although Japan Audit & Supervisory Board Members Association (former The Japan Corporate Auditors Association or "Kansayaku Kyokai") recommends "Audit & Supervisory Board Member" as English translation for "Kansayaku"

expect readers of this book to use the Itemized Discussion section merely as referential examples of viewpoints or ways of thinking.

Because much of this book is devoted to the explanation of elementary issues, Independent Directors/Auditors who are engaged in high level businesses may be dissatisfied with its contents. It is important to note, however, that making professional suggestions or high level discussions are not what is most required of Independent Directors/Auditors. Rather, the fundamental role of Independent Directors/Auditors is to ask simple questions regardless of corporate culture or unspoken agreements. We hope directors/auditors with advanced knowledge and a great deal of experience will also pick up this book in order to reconfirm the basics.

In writing this book, we have received valuable suggestions and advice from many parties related to listed companies, academic authorities, and practitioners including Nagashima Ohno & Tsunematsu. We greatly appreciate the significant help Ms. Michiko Kawato contributed in the effort to publish this book.

We sincerely hope this book will provide assistance in the activities of Independent Directors/Auditors.

October 2012

Tokyo Stock Exchange, Inc.

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General Discussion

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General Discussion

1. The Expected Role of Independent Directors/Auditors

TSE's rule requiring a listed company to secure at least one Independent Director/Auditor (the "Independent Director/Auditor System") aims at appropriately protecting the interests of general shareholders, which play an important role in the stock market by providing liquidity to the market, making them indispensable stakeholders of a listed company. Under the Independent Director/Auditor System, listed companies must have one or more outside director/auditor who is unlikely to have conflicts of interest with general shareholders and notify Tokyo Stock Exchange of their appointment as "Independent Director(s)/Auditor(s)."

Outside directors/auditors who are appointed by a listed company as Independent Directors/Auditors are expected to act in order to appropriately protect interests of general shareholders, which are important stakeholders of the company. The Advisory Group on TSE Listing System Improvements stated the following in its report titled "Expected Role of Independent Directors/Auditors" that was published in March 2010:

Independent Directors/Auditors are expected to take actions in light of protecting interests of general shareholders, by, for example, raising necessary opinions at a meeting of the board of directors making certain decision on executing businesses, so that interests of general shareholders are respected.

What is actually meant by "taking actions in light of protecting interests of general shareholders?" Are the actions to be taken by Independent Directors/Auditors different from those to be taken by other directors or corporate auditors?

Generally, corporate actions of listed companies are mainly intended to make profits continuously and to enhance corporate value. General shareholders are able to obtain returns from their investment if corporate value is enhanced, which mean the interests of general shareholders and those of listed companies are generally correspondent. Directors and corporate auditors of a listed company should take actions to enhance corporate value through the pursuit of the company's business goals, and this also applies to Independent Directors/Auditors. Independent Directors/Auditors do not necessarily owe a special obligation to the company or shareholders.

Internal directors, however, generally advance the businesses of the company themselves, based on the guidance of the CEO. Therefore, it is difficult for us to expect such directors to take actions from the objective viewpoint of enhancing corporate value for shareholders. In other parts of the world, this objective viewpoint is expected to be raised by outside directors. In Japan, however, even those who have a significant business relationship with a listed company are allowed to serve

as its outside director, which means even outside directors have difficulties maintaining an objective viewpoint. Meanwhile, general shareholders of a listed company have little effect on the management of the company because of their minority shareholding, and company management is structured in a manner in which the interests of general shareholders are unlikely to be appropriately considered among the various interests of stakeholders.

In order to protect the interests of general shareholders appropriately, we must secure someone who will proactively work to do so in the course of decision making at the listed company, such as during board meetings. TSE established the Independent Director/Auditor System expecting Independent Directors/Auditors to play such roles. The significance of their roles become more necessary in the event of management buy-outs, introductions of anti-takeover rules, and capital increases by way of third party allotments, all of which are typical cases where conflict of interests between management and shareholders of listed companies rise to the surface.

The legal power and responsibilities of Independent Directors/Auditors are not special compared to those of other outside directors or outside corporate auditors. Regardless of whether or not a director/auditor is appointed as Independent Director/Auditor, there is no change to the basic principle that they should act to enhance corporate value through the pursuit of the company's business goals. Independent Directors/Auditors, however, are appointed by listed companies to be responsible for protecting interests of general shareholders. Thus, they are expected to proactively work to do so by, for example, seeking opportunities to express opinions, asking questions, confirming details, and identifying issues, so that the interests of general shareholders are appropriately considered and fair and impartial decisions are made.

Put simply, Independent Directors/Auditors are appointed by the company as representatives of the interests of general shareholders.

2. Matters of Attention for Independent Directors/Auditors

What matters should Independent Directors/Auditors of a listed company actually take into consideration when taking actions to protect the interests of general shareholders, such as in meetings of the board of directors? In this section, we will explain general matters of attention for Independent Directors/Auditors, while specific matters related to agendas in meetings of the board of directors will be explained in the Itemized Discussion section.

(a) Are interests of general shareholders adequately considered?

In relation to company decision making, Independent Directors/Auditors are expected to consider whether the interests of general shareholders are adequately considered and whether all attendees (directors or corporate auditors) of board meetings are making decisions with a shared awareness of such issues.

For instance, with respect to a decision making on new capital expenditure, Independent Directors/Auditors are expected to consider whether the decision on such new investments is objectively reasonable for enhancing corporate value of the listed company, and to evaluate such decision as a result of such consideration.

Corporate value, from the viewpoint of general shareholders of a listed company, is theoretically the aggregate of the present value of future cash flows of the listed company. In order to enhance such corporate value, the listed company is required to profit more than the costs of the capital that investors expect.

From this viewpoint, it is essential that the new investment generates profits which are greater than the costs of capital. Internal directors/auditors, however, sometimes do not give adequate consideration to such viewpoint. Therefore, Independent Directors/Auditors are expected to ensure the interests of general shareholders are considered in company decisions by asking questions, confirming details, seeking explanations from management, and, if necessary, recommending reconsideration.

As a result of Independent Directors/Auditors continuing to raise such issues, it becomes standard for these interests to be considered during board meetings. If this practice spreads throughout the whole company, the interests of general shareholders become considered even in daily decision making. Through this process, we can expect that reasonable decision making from the viewpoint of executing business goals and enhancing corporate value will occur on a company-wide level.

(b) Is the necessary information is appropriately provided?

In order for directors/auditors to pay attention to the interests of general shareholders in their decision making, the information necessary for evaluation from such viewpoint should be fully provided in advance.

If there is a lack of referential materials related to information necessary for consideration from the viewpoint of general shareholders' interest during board meetings, Independent Directors/Auditors are expected to act so that company decisions are made with the appropriate information by asking questions or confirming details regarding the insufficient information. It is thought that doing so will lead to the necessary information being provided in the referential materials for future board meetings.

In cases like the new capital expenditure mentioned above, information on how much profit is expected to be generated from such new capital expenditure, or whether such profit is more than the cost of capital of the listed company is typically required in order for the relevant board member to consider whether such new capital expenditure is reasonable from the viewpoint of enhancing corporate value of the listed company.

If there is insufficient information on whether the expected profit or cash flow from new capital expenditure is more than the cost of capital, Independent Directors/Auditors are expected to ask for such information. Even if the expected profit or cash flow from new capital expenditure is more than the cost of capital, if certain assumptions in the expected profit plan are too optimistic to be realized, Independent Directors/Auditors are expected to ask for explanation on such assumptions.

It is one of the essential roles of Independent Directors/Auditors to ensure that board members are appropriately provided with the necessary information to consider the interests of general shareholders by asking questions or confirming details.

Gathering information is an important factor to be reviewed when legal liability of directors or corporate auditors is pursued.

There are various methods of judicial review of the responsibilities of directors or corporate auditors, however, there is judicial precedent which states that, when considering such responsibilities, the court should examine whether careless misrecognition occurred regarding the facts on which certain decisions are based, and whether the decision making process based on such facts is materially unreasonable from the viewpoint of business person of ordinary, sound judgment. The issue regarding the appropriateness of business decisions is whether it is "materially unreasonable," while the issue for the awareness of facts on which that decision is made is whether such misrecognition is careless. As such, more so than the business judgment itself, prudent approach is demanded for the gathering of necessary information.

Asking necessary questions and confirming details on the information necessary for corporate decisions may protect the management members of the company.

(c) Understanding of Concerns or Expectations of General Shareholders

Independent Directors/Auditors are expected to make an effort to remain highly sensitive to general shareholders' concerns and expectations.

Such efforts include directly hearing investors' requests by attending meetings between listed companies and investors, such as financial results briefings, or indirectly understanding investors' requests by receiving periodical feedback on the investor relations activities of the company.

It is part of the fundamental structure of stock companies (*Kabushiki Kaisha*) to raise profits from various outside economic activities and distribute such profits among its shareholders. Shareholders invest money in the company to receive a part of profits generated from its business activities, in the form of dividends or capital gain. Therefore, it would be helpful to understand financial theory, the foundation of investment theory, in order to understand the viewpoints of general shareholders.

(d) Improvement of Environment for Independent Directors/Auditors

In order for Independent Directors/Auditors to appropriately execute their roles in protecting the interests of general shareholders, it is essential that all directors, corporate auditors, or executives of the listed companies (i) fully understand the expected role of Independent Directors/Auditors and (ii) improve the company's environment, so that Independent Directors/Auditors properly function, by establishing a system of distributing information to Independent Directors/Auditors in timely and appropriately manner or collaboration between Independent Directors/Auditors and other internal departments, and securing certain personnel that support Independent Directors/Auditors. Independent Directors/Auditors are required to request that listed companies improve such environment, and listed companies are required to improve such environment in advance (if requested by Independent Directors/Auditors, upon such request).

With respect to improvement of such environment, there is no framework common to all listed companies. Each listed company must create its framework based on its fundamental theory of corporate governance.

The following are examples of such efforts made by listed companies:

i) Management explain to Independent Directors/Auditors matters to be decided or important matters to be reported at a board meeting in advance, so that Independent Directors/Auditors may fully understand those matters and take appropriate actions from the viewpoint of protection of general shareholders' interests;

ii) Independent Directors/Auditors exchange information with internal audit department or internal control department of the listed company in a timely and appropriately fashion and appropriately collaborate with them, in order for them to secure personnel or frameworks that would support Independent Directors/Auditors in taking appropriate actions to protect the interests of general shareholders;

iii) In cases where there are two or more Independent Directors/Auditors, Independent Directors/Auditors are ensured opportunities to exchange opinions with one another such as periodical meetings between/among them, so that Independent Directors/Auditors may cooperate with one another to properly fulfill their expected role; and

iv) Independent Directors/Auditors are ensured opportunities to exchange opinions with other outside directors/auditors, corporate auditors, accounting auditors, or the management, such as through periodical meetings, so that Independent Directors/Auditors may receive necessary information in a timely and appropriately fashion and promote collaboration or smooth communication with other internal departments.

3. Q&A regarding Independent Directors/Auditors

The following Q&A contains information which will be useful when reading this book.

Question:

Why, out of the many stakeholders of a company, do general shareholders in particular need someone who represents their interests?

Answer:

There are many stakeholders in a company, such as shareholders, creditors, client companies, employees and customers. Shareholders differ from other stakeholders primarily in two ways.

First, shareholders of a company have no negotiation powers against the company. Shareholders perform their obligation to a company by making a financial contribution. Thereafter, they can only wait for dividends from the company. Other stakeholders have negotiation powers against the company through such means as not fulfilling obligations to deliver purchased goods if the company does not make payment.

Second, return on investment for shareholders is not guaranteed. They are not able to receive any distribution of the residual assets unless the company dissolves, and they receive no dividends nor capital gain unless the company makes a profit, while other stakeholders may receive payment by fulfilling obligations such as delivery of purchased goods.

The above two points are common to all shareholders. That is why shareholders have voting rights at the general meeting of shareholders, which is the ultimate decision making body of a company. If a shareholder is a controlling shareholder or major shareholder, such shareholder may exert influence on the management of the company with their voting rights. However, general shareholders may not have any influence on the management by exercising their voting rights.

Although general shareholders are indispensable for companies, their interests are likely to be neglected in the current form of stock companies, and thus we need someone who specifically represents their interests.

Question:

Independent Director/Auditors represent the interests of "general shareholders." What do "general shareholders" actually mean? Are they non-institutional individual shareholders? Aren't institutional investors included in general shareholders because of their profession?

Answer:

There is no exact definition of "general shareholders." However, TSE uses "general shareholders" to mean shareholders that may change as a result of transactions in the market and minority shareholders that do not have a significant effect on a company's management. Both an individual shareholder and an institutional shareholder may fall within the category of "general shareholder," as long as such shareholder is not a major shareholder that exerts control over the company.

Question

Do general shareholders exist only in listed companies?

Answer

In non-listed companies, there are also minority shareholders that do not have a significant effect on the management. However, shareholders that may continuously change as a result of transactions in the market exist only in listed companies.

Question

Specifically whose interests are interests of general shareholders?

Answer

Interests of general shareholders do not mean interests of particular shareholders.

General shareholders have no interests in the company other than interests as shareholders, and they may enjoy such interests only through the enhancement of corporate value. Such interests are common to every shareholder, and we can call such interests "shareholders' common interests."

Corporate activities of listed companies generally aim to enhance their corporate value, which means the interests of general shareholders of a company generally coincide with the pure profit of that company.

Question

Is it possible for us to estimate "corporate value?" If possible, what kinds of methods are there?

Answer

Some people say that "corporate value cannot be estimated." However, if companies aim to enhance their corporate value, their corporate actions are ambiguous without an estimation of corporate value. Capital markets provide listed companies with opportunities to have their corporate value calculated in the form of their stock price. If some listed companies adopt a stance that corporate value is unable to be estimated, such stance negates the market. It is the first agreement between the market and a listed company that the listed company adopts the stance that corporate value can be estimated, in order for the listed company to face the capital market and consider the interests of general shareholders.

There is also the view that the market capitalization of a listed company represents the corporate value of the company. Market capitalization, however, tends to be affected by various events surrounding companies, as we saw in the recent Lehman Shock or the sovereign debt crisis in Europe, and they are overvalued or undervalued if information disclosure by listed companies is insufficient, or the market function evaluating or analyzing such disclosed information does not function well.

Therefore we generally adopt methods other than market capitalization when we use corporate value internally as a management benchmark. Discount cash flow (DCF) analysis, which is the aggregate of future free cash flow projections discounted to arrive at present value, are widely used among various methods for corporate value estimation.

We note that there was the following description in the report titled "Takeover Defense Measures in Light of Recent Environmental Changes" that was published by the Corporate Value Study Group of the Ministry of Economy, Trade and Industry in June 2008:

In the "Guidelines" [Editor's note: Meaning "Guidelines Regarding Takeover Defense for the Purposes of Protection and Enhancement of Corporate Value and Shareholders' Common Interests" published by the Ministry of Economy, Trade and Industry and the Ministry of Justice on May 27, 2005], "corporate value and the shareholders' common interests" is referred to as "shareholder's common interests"…., and this report will follow this usage of the term. In relation to this, "corporate value" appearing in the "Guidelines" and in this report is conceptually assumed to be "the discounted present value of future cash flow of the company." This concept should not be arbitrarily stretched in the interpretation of the "Guidelines" or this report.

Question

What is the difference between the interests of the company and those of general shareholders?

Answer

Basically, the interests of a company and those of its general shareholders are the same.

There are, however, cases where the interests of the company and those of its shareholders do not match. In the event of a cash-out of minority shareholders, for example, the increase of the amount of cash to be paid to minority shareholders is beneficial to general shareholders as minority shareholders, while it is not beneficial to the company because it will lead to an increase in cash drain from the company.

Question

Shouldn't other directors/auditors represent the interests of general shareholders?

Answer

All directors and corporate auditors of listed companies are entrusted by shareholders to enhance corporate value, which means that all are expected to give consideration to the interests of general shareholders in decision making, regardless of whether or not they are Independent Directors/Auditors.

Internal directors, however, are expected to execute the company's business under the direction of the CEO, which requires balancing the various interests of stakeholders. Therefore, it is difficult for us to expect such internal directors to take actions objectively from the viewpoint of enhancing corporate value. This also applies in cases of outside directors who have a significant transactional relationship with the listed company. It is likely that the interests of general shareholders will not be considered appropriately, because they are not influential to the management of the company.

Thus, we need to secure someone who may objectively express opinions from the viewpoint of general shareholders in the company's decision making process such as in meetings of the board of directors. This is the role of Independent Directors/Auditors.

Question

Aren't Independent Directors/Auditors required to consider the interests of stakeholders other than general shareholders?

Answer

Cooperation from stakeholders other than general shareholders, such as client companies, employees or local communities, is essential for the business activities of listed companies. Without

such cooperation, listed companies are not able to enhance their corporate value by continuously increasing profits. Therefore, listed companies are required to consider interests of such stakeholders.

There are cases, however, where there are conflicts of interest among stakeholders of a company, including general shareholders. In such cases, certain considerations are automatically expected to be made for stakeholders other than general shareholders, while it is unlikely that interests of general shareholders will be fully considered. That is why Independent Directors/Auditors are expected to participate in the decision making process of the company, and to ensure the company's decisions are made as a result of consideration of all stakeholders' interests.

Question

I understand that listed companies are required to appoint one (1) or more Independent Director(s)/Auditor(s) from among their outside director(s)/auditor(s). Why are Independent Directors/Auditors required to be appointed from among the outside director(s)/auditor(s)?

Answer

Because Independent Directors/Auditors are expected to represent the interests of general shareholders in board meetings and other areas, and are required to take actions objectively in consideration of shareholders' common interests, an individual who is likely to be influenced by the management or other stakeholders is not qualified to serve as an Independent Director/Auditor. Internal directors usually execute the company's business under the direction of the CEO, which means they are likely to be influenced by the CEO. Thus, TSE requires listed companies to appoint Independent Directors/Auditors from among the outside director(s)/auditor(s), as they are unlikely to be under the influence of the CEO, on condition that such individual meets further strict requirements regarding independence.

Question

Are the legal authority and responsibilities of Independent Directors/Auditors different from those of other outside directors/auditors?

Answer

Although Independent Directors/Auditors are expected to express opinions and take actions in order to protect the interests of general shareholders, they are still outside directors or outside corporate auditors under the Companies Act of Japan. Therefore, their legal authority and responsibilities are the same as those of other outside directors and outside corporate auditors.

Question

Is it possible for us to expect Independent Directors/Auditors to play unique roles without giving them unique authority?

Answer

The expected roles of Independent Directors/Auditors are not special. All directors/auditors are required to participate in the listed company's decision making while giving consideration to the interests of general shareholders. Among them, Independent Directors/Auditors are considered the most appropriate persons to consider the interests of general shareholders, and are essentially responsible for general shareholders. The legal authority of Independent Directors/Auditors is different depending on whether they are outside directors or outside corporate auditors. There are many things that can be handled by Independent Directors/Auditors given such authority.

Question

I understand that not all outside directors/auditors are necessarily qualified to be Independent Directors/Auditors. What qualifications are required for outside directors/auditors to be Independent Directors/Auditors?

Answer

Outside directors/auditors who further meet certain requirements may become Independent Directors/Auditors. Such requirements mainly consist of two elements.

The first requirement is not being significantly controlled by the management. Outside directors of a company are required to not have been employees or executives of the company. In addition, executives or employees of a subcontractor of the company have difficulties in going against the intentions of the company, and thus they are likely to be controlled by the management of the company.

The second requirement is not being able to significantly control the management. Employees or executives of a parent company or main clients of a company including a main financing bank are likely to control the company's management in order to benefit the organization to which they belong.

Outside directors/auditors who do not meet either of the above requirements are considered "not independent of the management" and are not qualified as Independent Directors/Auditors.

Question

May any outside directors who are highly independent of the management become Independent Directors/Auditors?

Answer

Any outside directors may become Independent Directors/Auditors if they are highly independent of the management. However, we cannot expect just any Independent Directors/Auditors to protect the interests of general shareholders. Independent Directors/Auditors are not necessarily familiar with businesses of the company and such familiarity is not required for qualification as Independent Directors/Auditors, unlike in the case of management. Instead, however, Independent Directors/Auditors are required to improve their understanding of the interests of general shareholders in order to objectively represent those interests.

This book aims at improving such understanding.

Question

If there is only one Independent Director/Auditor, can't we expect such Independent Director/Auditor to serve the same role as that expected to be played by independent outside directors in other countries?

Answer

If there exists only one Independent Director/Auditor in a company, he/she may have difficulties in influencing decision making at board meetings, and thus it may be difficult for us to expect such Independent Director/Auditor to fulfill the exact same role of supervising as the role expected to be played by independent outside directors in other countries. There are, however, things which can be achieved by one Independent Director/Auditor. Independent Directors/Auditors serve the important role of actively asking questions and confirming details of the related agenda, so that discussions and considerations in decision making (such as discussions at board meetings) are made from the viewpoint of protecting general shareholders' interests. If independent directors/auditors have voting rights at board meetings, they may exercise such voting rights from such viewpoint.

We should note that appointment of one Independent Director/Auditor is the minimum requirement for listed companies under TSE's rules requiring one or more Independent Director(s)/Auditor(s). The framework of corporate governance most appropriate for a listed company will differ depending on the size, businesses, composition of shareholders, and culture of such company. If there are any reasons why Independent Directors/Auditors are not able to effectively function, Independent Directors/Auditors are expected to propose to the management changes in governance framework, or deployment of support functions for Independent Directors/Auditors.

Question

If an outside corporate auditor is appointed as an Independent Auditor, can't we expect such outside auditor to fulfill the same function as that of independent directors in other countries?

Answer

Since outside corporate auditors have no voting rights at board meetings, it may be difficult to expect them to fulfill the same function as that of independent directors in other countries. There are, however, matters to be expected to be fulfilled by outside corporate auditors as Independent Auditors. Independent Directors/Auditors serve the important role of actively asking questions and confirming details of the related agenda, so that discussions and considerations in decision making (such as discussions at board meetings) are made from the viewpoint of protecting general shareholders' interests.

Question

I understand that Independent Directors/Auditors are the system for protecting interests of general shareholders. Are they beneficial to other stakeholders of companies such as client companies and employees?

Answer

Protecting the shareholders who are the last to receive the profits of the company will lead to securing the profits of other stakeholders such as client companies or employees. While in the short term there are cases where the interests of general shareholders and those of other stakeholders are in conflict, protecting the interests of general shareholders is connected to securing other stakeholders' interests in the medium-and long-term.

Question

Are Independent Directors/Auditors beneficial to members of the management, such as the CEO?

Answer

If Independent Directors/Auditors are beneficial to a company, such fact itself is of great help of the company's management including the CEO. In addition, Independent Directors/Auditors serve to protect the management from liabilities for damages. Under the Companies Act of Japan, the management, including the CEO, is liable for damages to the company caused by negligence of his/her duties. Examining whether or not they neglect their duties, i.e., whether or not they perform their duties with care, involves questioning whether information gathering, investigation or consideration was conducted reasonably based on the circumstances at the time.

Consideration will be given during the examination of whether information gathering, investigation or consideration were reasonably conducted to the fact that that Independent Directors/Auditors raised issues necessary for consideration from the viewpoint of protecting the interests of general shareholders, and whether certain decisions were made as a result of shared recognition of such issues among all directors and corporate auditors present at the board meeting.

Question

Do Independent Directors/Auditors contribute to preventing the company from scandals or enhancing corporate value?

Answer

Independent Directors/Auditors are appointed among outside directors/auditors, and they are considered to contribute to enhancing corporate value and preventing corporate scandals.

Prevention of corporate scandals or enhancement of corporate value is some of the most important goals of corporate governance, and the board of directors is recognized as playing a central role toward such. (In Japan, corporate auditors and the board of corporate auditors also play a part in such roles.)

Since corporate scandals usually occur in the course of executing business, they are not easily uncovered without the assistance from employees or executives who execute such business. It is, however, difficult for us to expect internal employees or executives to take corrective action if the top management of the company including the CEO is involved in such corporate scandals. Thus, outside directors/auditors, especially Independent Directors/Auditors, being independent of the management are expected to prevent such scandals from occurring, or to lead efforts in preventing the expansion of such scandals.

With respect to the enhancement of corporate value, such enhancement is usually attained as a result of execution of companies' businesses, which may be only performed by internal employees or executives. Independent Directors/Auditors, however, can be engaged in the decision making process at board meetings as outside directors/auditors, and they are expected to contribute to better decision making for the purpose of enhancing corporate value by providing the viewpoints of general shareholders, such as the costs of capital, in discussions on business plans at meetings of the board of directors.

If enhancement of corporate value becomes slow, or corporate value is impaired by poor business performance, changes in management policies become necessary. It is, however, difficult for us to expect internal executives to implement such changes. Outside Directors who are appointed as Independent Directors and are independent of the management of the company are expected to supervise the establishment and execution of management plans, and to propose revision of management policies, if necessary.

Question

What is cost of capital?

Answer

The "cost of capital" is the returns expected by investors viewed from the side of the corporation.

When considering costs of capital, we need to understand that investors choose an investment destination from multiple candidates. For instance, an investor who has one million yen on hand may choose the investment destination from government bonds, bank deposits, corporate bonds, stocks, investment trusts and other options.

When the investors purchase stocks of listed Company XX the hurdle rate (the minimum rate) will be calculated as the interest rate of government bonds that are generally considered risk free, plus a risk component (risk premium) considering market risk and the risk of Company XX's stock.

Such returns expected by investors becomes the term "cost of capital" if viewed from the company's perspective. This investor loses the opportunity to invest in government bonds by investing in the stock of Company XX, and the investor may obtain only negative returns from Company XX if the returns from Company XX are below the interest rate of government bonds. Company XX is able to succeed in "Value Creation" for general shareholders only when it generates returns at the same level or more of such expected returns, by which the corporate value of Company XX increases. In other words, corporate value is created only when the return on equity (ROE) that equals to Net Income divided by Shareholder's Equity exceeds cost of capital. Creation of corporate value is as shown in the following model:

Return Generated from Corporate Actions≧Returns Expected by Investors→ Creation of Corporate Value

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Itemized Discussion

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Itemized Discussion

How to read this "Itemized Discussion" section?

In this "Itemized Discussion" section, we describe, for each matter to be decided at board meetings, the "Outline of Agendum" and "Issues on Agendum" on the left page of each two page spread, and the "Viewpoint of General Shareholders" and "Checklist" on the right page. We thereafter give some "Commentary" on related issues and the ways of thinking on such agendum.

"***OUTLINE OF AGENDUM***" does not necessarily reflect actual situations. Please understand such outlines are our efforts to make the issues involved clear.

"***ISSUES ON AGENDUM***" are based on the facts mentioned in the "Outline of Agendum," while "***VIEWPOINT OF GENERAL SHAREHOLDERS***," "***CHECKLIST***" and "***COMMENTARY***" include matters not mentioned in the "***OUTLINE OF AGENDUM***."

The left pages aim at sharing images of each topic by outlining the agendum of a meeting of the board of directors relating to such topic. The right pages and thereafter cover various issues relating to the topic so that you can apply them to actual agenda which differ from the example.

"***CHECKLIST***" refers to points to be confirmed during discussion or consideration at board meetings. ◎ (meaning most preferable), ○(meaning preferable), and △(meaning less preferable) indicate the ranking of situations from the viewpoint of general shareholders. Such situations, however, depend on the circumstances surrounding each company and are not always applicable to all companies.

1. Resolution on Proposal for Election of Directors

OUTLINE OF AGENDUM

Resolve proposal for election of directors (a matter to be decided) to the general meeting of shareholders. Outline of biographical information on each candidate is shown in the referential material circulated separately.

Names of Candidates

Mr. XXXX

Mrs. YYYY

Mr. ZZZZ*

The mark "" indicates a candidate as Independent Director.*

ISSUES ON AGENDUM

i) The information necessary for the board members to judge independence of the candidate for an outside director is not provided.

ii) The company's attitude toward the current composition of board members and corporate governance is unclear.

iii) The criteria for selecting candidates and the selecting process are unclear.

VIEWPOINT OF GENERAL SHAREHOLDERS

General shareholders of a company are not able to significantly influence the management of the company, and they are forced to "give a blank check" to the management with respect to the business judgments of the company. Even if the process of business judgments is obvious at a glance to key persons in the company, or executives/employees who are familiar with the company's practices, it sometimes appears to lack transparency to general shareholders.

General shareholders of a company have no opportunity to know the personality and character of the company's management; they must make judgment on the management's adequacy based only on external elements such as background, gender, or nationality. General shareholders, however, may not entrust their assets if the composition of such elements are too unbalanced or if no one on the board represent their interests.

Independent Directors/Auditors are expected to give special consideration to the interests of general shareholders, and thus their independence is expected to be assured in both fact and appearance.

CHECKLIST

☑ Is the number of board members and its composition appropriate?

- △: The appointment of executives is considered the sanctuary or exclusive right of the CEO, into which no one may interpose.
- ○: The appointment process of directors is transparent and the diversity of board members is secured in accordance with the company's business and composition of shareholders.
- ◎: General shareholders are fully informed that the number of directors and the composition thereof are the most suitable for the company via a convocation notice of a general meeting of shareholders or other methods.

☑ Is the Independent Director(s)/Auditor(s) sufficiently independent of the management?

- △: Although the director meets the formality requirements for Independent Directors/Auditors, he/she is in fact likely to be easily controlled by the management because of certain circumstances affecting his/her independence of the management, such as a relationship as friends.
- ○: The director meets the requirements for Independent Directors/Auditors under the listing rules. In addition, the company established its own criteria for independence including concurrent posts, term of office, and personal qualities of Independent Directors/Auditors, in order to pay further attention to their independence.
- ◎: It is understood and accepted that argument with management decisions is a role of Independent Directors/Auditors.

COMMENTARIES

(a) Significance of Proposal for Election of Directors

With respect to a company with a board of auditors, the board of directors has the authority to propose the election of directors to a general meeting of shareholders (Article 298, Paragraph 4), while at a company with committees, the nominating committee has such authority (Article 404, Paragraph 1).

The board of directors is expected to appropriately supervise the company's management by evaluating whether it is executed appropriately and effectively and reflecting such evaluation in the appointment or dismissal of the management or changes to their compensation, meaning it plays a central role in corporate governance.

The result of resolutions at shareholders meetings are required to be disclosed after the relevant shareholder meeting by filing an "Extraordinary Report" under the Financial Instruments and Exchange Act, which shall include the information of the ratio of affirmative and dissenting votes. We should also note that the ratio of affirmative and dissenting votes in the elections of each director/auditor is also disclosed.

(b) Number of Board of Directors and Composition Thereof

Since the size and businesses of listed companies vary, there is no theoretical standard for the appropriate number of directors. It is important that the board of directors is able to make decisions in timely manner, and that check and balance functions among directors work well.

According to the "TSE-Listed Companies White Paper on Corporate Governance 2011," the average number of directors per company for all TSE-listed companies is 8.35. The number of directors tends to decrease gradually. The higher sales are, the higher the number of directors tends to be. Please refer to the "TSE-Listed Companies White Paper on Corporate Governance 2011," which has been published on TSE's website.

Composition of outside directors/auditors or internal ones in the board of directors and board of auditors also need to be considered. For example, companies with a board of auditors are not required to appoint an outside director, and approximately half of TSE-listed companies with a board of auditors in fact appoint outside directors, while appointment of outside directors is strongly demanded. The board of directors of a company needs to clarify the company's approach to this issue. Not only the viewpoint of "outside or internal," but also the viewpoint of "executive or non-executive" may be valuable to consider.

A recent popular topic relating to the board of directors is diversity within the board. Some people say that it is necessary for a company in order to survive in the rapid-changing global community to ensure it receives advice from various viewpoints by securing a diverse board of

directors in terms of age, gender, nationality and race instead of having a board composed only of internally promoted directors.

There are listed companies in Japan, which make efforts to secure diversity of their board of directors, in order to develop their business globally.

(c) Independent Directors/Auditors Notification and Information Disclosure

Who listed companies report as Independent Directors/Auditors to stock exchanges is not a matter to be decided at board meetings under the Companies Act of Japan, it is however usually confirmed at board meetings.

It is Independent Directors/Auditors who most understand the duties and responsibilities or qualifications for Independent Directors/Auditors. Thus, it is a good idea that the current Independent Directors/Auditors actively participate in the process of appointing Independent Directors/Auditors, and if there are any doubts on the independence of a candidate they should express such doubts.

Information on the independence of Independent Director/Auditor candidates is important information for shareholders to exercise their voting rights for the election of Independent Director/Auditor candidates. We should carefully pay attention to having such information appropriately transmitted to shareholders by a convocation notice of a general meeting of shareholders, Independent Directors/Auditors Notification, or direct communication with investors or voting advisors.

(d) What is the definition of "Independence" for Independent Directors/Auditors

According to the Report by the Corporate Governance Study Group of the Ministry of Economy, Trade and Industry, from which the Independent Director/Auditor System arose, independence means "the director/auditor is independent of the management, and has no interests or stake in the management," and we cannot consider such individual independent if: (i) the director/auditor is likely to be significantly controlled by the management, or (ii) the director/auditor is likely to significantly control the management. Executives or employees of the company in question, or those of subsidiaries or business counterparties of the company such as subcontractors, or consultants who receive certain compensation from the company, or family members thereof fall within category (i) above, and executives or employees of the parent company of the company in question, or those of the company's business counterparties such as the main financing bank, and the family members thereof fall within category (ii). TSE stipulated requirements for independence based on the items listed in the above report.

An employee of Company B, the parent company of Listed Company A is not qualified as an Independent Director/Auditor of Company A. This is because there is a possible conflict of

interests between Company B and other minority shareholders of Company A. Assuming that Company B plans to acquire 100% shares of Company A, such conflict of interests becomes actualized. Independent Directors/Auditors of Company A are expected to take actions as representative of minority shareholders (general shareholders) of Company A in order to maximize the interests of minority shareholders. It is, however, difficult for us to expect Mr. X who is an employee of Company B to take such actions. From the viewpoint of shareholders or investors who are not familiar with Mr. X, it is difficult to expect Mr. X to go against Company B, his employer, in order to protect the interests of the general shareholders of Company A. We can say such situation as not being independent in appearance.

Some readers may consider it unreasonable to disqualify candidates based only on "appearance." It may be possible for someone to make fair judgments for the interests of minority shareholders regardless of his/her title or position, and thus some people believe that actual independence is more important than independence judged on appearance.

We agree that actual independence is very important. It is however difficult for shareholders or investors, being outsiders of the company, to know whether each outside director/auditor is actually independent. Shareholders or investors are not able to know whether an Independent Director/Auditor actually protects the interests of general shareholders, or whether an Independent Director/Auditor is the appropriate person to whom shareholders should entrust their assets, in cases where the Company explains candidates' qualifications as Independent Directors/Auditors only by their actual independence. Thus TSE stipulated rules to exclude persons with a possible conflict of interests with general shareholders, that is, those who are not considered independent of the management in appearance, from qualification as Independent Directors/Auditors.

Under the TSE's Independent Director/Auditor System, Independent Directors/Auditors are defined as "an outside director/auditor who is unlikely to have a conflict of interest with general shareholders." Also, outside directors/auditors who are likely to have conflict of interests with general shareholders are categorized into several groups (see Chart 1-1).

If someone falls within any of these categories, he/she is not considered independent in appearance, and not qualified as an Independent Director/Auditor. It is noted, however, that someone is not necessarily considered independent even if he/she does not fall within any of such categories.

Chart 1-1 Categories that are likely to have Conflict of Interests with General Shareholders

a. A person who executes business of the parent company or fellow subsidiary of said company;
b. A person for which said company is a major client or a person who executes business for such person, or a major client of said company or a person who executes business for such client;
c. A consultant, accounting professional or legal professional (in the case of a group such as a juridical person or association, including persons belonging to such group) who receives a large amount of money or other asset other than compensation for directorship/auditorship from said company;
d. A person who has recently fallen under any of a. to the preceding c.;
e. A close relative of a person enumerated in any of the following (a) to (c) (excluding those of insignificance);
   (a) A person enumerated in a. to the preceding d.;
   (b) A person who executes business of said company or its subsidiary (including directors who do not execute business or accounting advisors (when any of such accounting advisors is a juridical person, including any member thereof who is in charge of such advisory affairs) in the case where said company designates its outside auditor(s) as an independent auditor(s)); and
   (c) Persons who have recently fallen under the preceding (b)

These formality requirements should be treated as a guide, and we must carefully consider whether a candidate is actually independent. TSE rules do not cover all categories that are likely to adversely affect independence. It is noted that there may be other relationship that jeopardizes independence.

According to "Expected Role of Independent Directors/Auditors" (please see Referential Materials section) we mentioned in General Discussion section, Independent Directors/Auditors are expected "to take actions in light of protecting the interests of general shareholders, by, for example, raising necessary opinions at meetings of the board of directors where decisions on executing business are made, so that the interests of general shareholders are respected."

In order to create a situation where shareholders and investors expect Independent Directors/Auditors to play such role, Independent Directors/Auditors need to be persons who are, in appearance, unlikely to be affected by interests other than those of general shareholders, such as the interests of an upper company in a capital relationship including the parent company, or a creditor

including a client company or financing bank. In addition, in order for Independent Directors/Auditors to take actions from the viewpoint of protecting the interests of general shareholders, they should be individuals who do not passively acquiesce to the CEO's decisions. Incumbent Independent Directors/Auditors are expected to participate in discussions on candidates for new Independent Directors/Auditors based on the viewpoints mentioned above.

(e) Significance of Independent Director(s)/Auditor(s) Having Voting Rights in the Board of Directors

TSE's Securities Regulations stipulate that "an issuer of listed domestic stocks shall make efforts to secure an independent director(s)/auditor(s) with consideration of the significance of a person(s) who holds voting rights in the board of directors being included in independent director(s)/auditor(s)." This rule was stipulated in May 2012, stemming from a series of corporate scandals revealed in the fall of 2011.

In all of such scandals, the only Independent Directors/Auditors appointed were outside corporate auditors. Therefore, such Independent Auditors were not able to exercise their voting rights even in the extraordinarily critical situation where a CEO tried to investigate the wrong-doing of his predecessor and was dismissed by such predecessor. In other cases, Independent Directors/Auditors have difficulties in making an objection to the management calling subsidiaries his own.

The Independent Director/Auditor System has been established on the assumption that every company does not have an outside director, and thus it does not matter to TSE whether an Independent Director/Auditor is a director or corporate auditor as long as he/she is an outside director/auditor that is highly independent of the management. Such scandals reveal that there are cases where Independent Directors/Auditors have difficulties in playing their expected roles unless there exists among them a person with voting rights in the board of directors, i.e., outsider director.

In other words, if there is among Independent Directors/Auditors an outsider director who has voting rights in the board of directors, Independent Directors/Auditors are in a better position to play their role.

This is the significance of a person who holds voting rights in the board of directors being included in Independent Directors/Auditors. When considering the composition of the board of directors, a company is required to conduct discussions based on the viewpoint mentioned above.

(f) Proxy Advisory Services and Fiduciary duties of Institutional Investors

These days, when the season of general shareholders' meetings approaches, the movements of proxy advisory services, such as ISS (Institutional Shareholder Services Inc.) and Glass Lewis (Glass Lewis & Co.), always becomes a popular topic

Among institutional investors that make investments in Japanese listed companies, there are those that invest in many issues aiming to replicate the movements of an index such as TOPIX, instead of making investment in specific issues. Such institutional investors own stocks of many listed companies and are not able to carefully consider each agendum proposed in a meeting of the general shareholders of each company.

We note that the fiscal year of 75% of listed companies ends in March, and many of these companies hold ordinary meetings of general shareholders in late June. This is one of the reasons why investors are not able to consider each agendum. In 1990s, more than 90% of listed companies held their ordinary meetings of shareholders on a single day, while such rate has decreased to approximately 40% at present. That is certainly progress from the viewpoint of improvement of environment for making it easier for shareholders to exercise their voting rights. Still, ordinary general meetings of shareholders tend to be held in late June in a focused way on weekly basis, rather than daily basis.

With such background, proxy advisory services analyze each agendum of each company on behalf of investors, and then offer advice on how to exercise voting rights. Many institutional investors use such proxy advisory services, and thus proxy advisory services have great effect on listed companies in Japan. Especially, with respect to a listed company held by foreign investors at a high rate, if ISS or another proxy service recommends a vote against the agendum of a shareholders' meeting, such agendum is less likely to be approved.

Proxy advisory services establish their proxy voting policies on whether they recommend a vote for/against an agendum for each category of agenda, and offer advice based on such policies. For example, ISS's policy for director election in 2012 stated that it would recommend a vote against election of a "top executive at a company that has a controlling shareholder, where the board after the shareholder meeting does not include at least two independent directors based on ISS independence criteria for Japan." This is only one example among many, and the actual policy provides for matters such as responses for director elections of a company without outside directors, and independence criteria. The whole text of such policy has been available to the public on their website, which we suggest you check.

Needless to say, there are many institutional investors that do not use advice from proxy voting services. There are some domestic institutional investors that have their own voting policy for the agenda of general shareholders meetings, and have it available on their website.

Why do institutional investors take time to express opinions on the corporate governance systems of listed companies such as independence of directors? Can we say that if there is something unacceptable in a company, investors may sell their shares of the company's stock? There are reasons why we cannot do so. We note that someone who conducts index-linked investment has difficulty in selling a particular issue. If an investor who manages significant assets sells one issue, that may cause significant changes in the price of the issue (decrease of stock price), and the investor must be prudent in such selling.

Meanwhile, institutional investors owe fiduciary duties. Institutional investors are entrusted with assets and management thereof by many customers (purchaser of investment trust fund, or participant of a pension plan) in the form of investment trust fund or pension assets for management. Under fiduciary duties, a fiduciary must be loyal to the beneficiary. This is commonly understood in Europe and the U.S., and in the U.S., the fiduciary duties of institutional investors that manage corporate pension assets have been stipulated in laws since 1980s. In the U.K. as well, the Stewardship Code has recently been clarified to stipulate the fiduciary duties of institutional investors.

Since institutional investors sometimes have difficulties in selling a particular stock, they must exercise their voting rights at a meeting of general shareholders so that interests of beneficiaries are maximized, in order to perform their fiduciary duty.

As mentioned above, since institutional investors and proxy voting services have influence on voting for or against the agenda of general shareholders meetings, listed companies need to pay attention to how to provide information to shareholders or investors when making decision on proposal for election of directors, etc.

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2. Appointment of Representative Director(s)

OUTLINE OF AGENDUM

The Company appoints its representative director as follows:

(Newly Appointed)

Name:	Mr. XXXX
New Title:	Representative Director, CEO

(Retired)

Name:	Mr. YYYY
Ex-title:	Representative Director, CEO

ISSUES ON AGENDUM

i) The criteria for appointing a new representative director and its process are unclear.

ii) The reason and background of the retirement of the ex-representative director are unclear.

VIEWPOINT OF GENERAL SHAREHOLDERS

Appointment of a representative director is important for all stakeholders of the company because the person who assumes the position of representative director of the company significantly affects the performance of the company. From the viewpoint of general shareholders, this is a very important opportunity for them to examine whether the board of directors effectively supervises the representative director.

There is a case where the interests of the company will be harmed if the contents of discussions during the process of appointing representative directors are disclosed. Therefore some companies may prefer to keep them undisclosed. The company should, however, disclose more information in cases where general shareholders are concerned about the situation, such as those of a significant corporate scandal or significant changes in appointment policy. If a company is not able to disclose the process of appointing a representative director, Independent Directors/Auditors are expected to confirm the appropriateness of the appointment process.

CHECKLIST

☑ The process of appointing a new representative director is appropriate.

△: Appointment by the retiring president (*shacho)* or retiring chairperson (*kaicho*) is everything. It is realistically difficult for the board members to express unfavorable opinions.

○: Unbiased discussion on appointment of a representative director is freely and actively conducted at a board meeting, including invitation of a candidate from outside the company.

◎ : Performance of the representative director is periodically discussed at board meetings, which actively acts as an evaluation/supervising body.

☑ Information disclosure is appropriately made.

△: Matters relating to appointment of representative directors are strictly confidential regardless of actual contents.

○: The Company discusses and considers the appropriateness or necessity of information disclosure, taking into consideration whether such appointment receives the attention of general shareholders or the public (whether necessity of disclosure is high) or if future discussion in the board of directors suffers because of disclosure.

COMMENTARIES

(a) Significance of Appointment or Removal of President

It is the authority of the board of directors to appoint or dismiss representative directors or representative executive officers (the title varies by company, President (*shacho*) or CEO, hereinafter referred to as "CEO" for convenience.).

It is required for the new CEO to contribute to the enhancement of corporate value. Furthermore, the process for appointing appropriate candidates should be also considered.

Independent Directors/Auditors are different from internal directors/auditors in that internal directors/auditors work under the CEO as executive members, while Independent Directors/Auditors do not have such a relationship with the CEO. Independent Directors/Auditors are expected to express opinions that internal directors/auditors are hesitant to express.

We note that there are cases where Independent Directors/Auditors have difficulties in deciding which of two conflicting opinions are correct, because they are not familiar with internal circumstances or personal relationships.

It may be possible way for companies to deal with such cases by having Independent Directors/Auditors examine whether the information provided is enough to determine their opinion on the proposal in question and whether the background for such proposal has been fully clarified, and ask for further explanation if some information is missing.

A change in CEO of a company usually garners attention from the media, and affects investment decisions. Thus, it is required for the company to make timely disclosure or file an extraordinary report if a change in CEO is decided. Especially, if a motion for dismissal of the representative director is made under urgent circumstances, rather than a change in CEO at the end of the expected term, such change may be reported as a dismissal or internecine battle, and thus significantly affects shareholders. Independent Directors/Auditors should take care in how information is disclosed in such cases.

(b) Succession Plan

No CEO may hold the position forever, even if he/she is very talented and makes excellent contributions to the company's performance. The CEO must pass the office to a successor someday. Thus it is necessary for a CEO to make a plan for appointing a successor in order to select a candidate as the next leader. This is a succession plan. In order to select and cultivate a candidate for CEO, some companies introduce a system under which the company can systematically manage possible candidates for executives from early stages.

With respect to companies with committees, nominating committees under the Companies Act have an authority to make proposal on appointment or dismissal of directors. Likewise, there are cases of companies with (a board of) auditors where the company voluntarily establishes a body for

nomination or compensation such as an advisory board. By involving Independent Directors/Auditors, the company may ensure the transparency or fairness of the appointment process for the next CEO, whereas such process would likely be held behind closed doors without them.

Popular Examples of Change in CEO

The following are some examples of changes in CEO that have been highly publicized.

i) Example of Company A (Retailer)

Outline

A motion for dismissal of the CEO who found to be involved in a scandal which included illegal profit sharing was proposed and unanimously approved. An outside director from a bank played a central role in proposing such motion.

Notes

This was a pioneer case where outside directors played a central role in the dismissal of a CEO. The outside director who is considered to have played the central role in this case was from a financing bank, and he may be different from Independent Directors/Auditors who represent interests of general shareholders. There is however no difference between the interests of creditors and general shareholders in cases where the CEO of a company conducted certain criminal actions, such as aggravated breach of trust. The CEO himself was not notified in advance of the proposal for his dismissal, which was one of the distinct features of this case.

ii) Example of Company B (Electronic equipment manufacturer)

Outline

Company B announced that the CEO resigned his office for medical treatment. A few months after such announcement, the ex-CEO sent a letter to the company to withdraw his resignation.

Company B later announced that not medical treatment of the ex-CEO, but a certain problem involved in the divestiture project led by the ex-CEO was underlying reason for his resignation.

Notes

Company B claimed that the reason why it did not disclose the causes of the resignation of the CEO correctly was to avoid harmful rumors. It was, however, against TSE's rule that "A listed company shall make efforts to carry out its business faithfully, by, among others, always strengthening prompt, accurate and fair disclosure of corporate information from the viewpoint of investors, having fully recognized that timely and appropriate disclosure of corporate information to investors is the basis of a sound market

for financial instruments." This trouble had no small effect on stock price of Company B. Independent Directors/Auditors who represent general shareholders are required to pay special attention to transparency of decision making processes, and to encourage the company to disclose correct information to shareholders/investors.

iii) Example of Company C (precision instruments manufacturer)

Outline

The foreign CEO of Company C who had just assumed his office was dismissed by unanimous vote of directors present at a board meeting. Company C announced that there were significant differences between the dismissed CEO and other management in terms of direction/methods.

It revealed that ex-CEO had pursued a case of longstanding fraudulent accounting before being dismissed and Company C in fact conducted such fraudulent accounting, and the responsibilities of directors/auditors involved in such fraudulent accounting were pursued.

Notes

In cases where an agendum for dismissal of a CEO is proposed, Independent Directors/Auditors have great difficulties in directly raising objections to such proposal if the reasons for dismissal of CEO are reasonably explained to some extent. Independent Directors/Auditors who are not familiar with internal circumstances or personal relationships have difficulties in deciding then and there which of two conflicting arguments is correct.

Independent Directors/Auditors who are not familiar with internal circumstances are able to take the following actions in such cases: (i) request that enough information be provided to determine their opinion on the proposal in question, and (ii) ask for postponement of the relevant resolution or have their objections recorded in the minutes if such information is not fully provided.

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3. Establishment of Executive Compensation Plan

OUTLINE OF AGENDUM

Compensation to be paid to each director shall be as follows:	
Representative Director:	XXX yen per month
Executive Directors (5 persons):	XXX yen per month in total. Decision on the amount to be paid to each director is left to the representative director within such total.
Outside Director (1 person):	XXX yen per month

ISSUES ON AGENDUM

i) Policy or approach to executive compensation is not provided.

ii) Decision on the amount to be paid to each director is left to the representative director without any limitation.

VIEWPOINT OF GENERAL SHAREHOLDERS

The compensation plan for directors of a company affects the management of the company, and is thus a matter of great concern for the company's general shareholders. The reason why many general shareholders pay attention to the plan is that it would affect management policies.

For example, if the compensation for directors is not connected with the performance of the company, then there is a lack of direct incentive for enhancing the performance of the company, which creates anxiety among general shareholders about the effectiveness of the company's management. We sometimes hesitate to express opinions on someone's compensation, because we feel as if it is interfering in the contents of colleagues' wallets. Independent Directors/Auditors are expected to recognize the significance of the compensation plans in corporate governance, and arrange to have such plans directly discussed.

CHECKLIST

☑ The decision making process for compensation reflects the purpose of laws and regulations.

△: It is the common recognition among the management that (i) compensation for directors/auditors should be within the range approved in the past at a general meeting of shareholders, and (ii) seeking for re-approval of shareholders should be avoided if possible.

△: Allocation of compensation is left to the representative director's discretion. Expressing an opinion on such allocation is considered taboo. Only the representative director knows the exact amount of compensation of other directors.

○: The "Policy on Deciding Executive Compensation," which has been disclosed in accordance with laws and regulations, is well recognized among the management and actual decisions are made following such policy. Revision of such policy is discussed and considered when necessary.

☑ Significance of compensation is well recognized.

△: Compensation of executives is not sharply distinguished from employee salaries. For example, it is an extension of seniority-based fixed salary. Precedents and examples of other companies are heavily weighed.

○: It is well recognized that compensation is one of the important components of governance, and an atmosphere of open discussion on such compensation is fostered.

◎: The connection between compensation and the company's business plans or performance is considered based on the company's business and the environment surrounding the company.

COMMENTARIES

(a) Rules for Compensation of Executives

With respect to companies with a board of auditors, compensation for directors/auditors are matters to be resolved by a general meeting of shareholders unless otherwise provided for in the articles of incorporation of the company (Articles 361 and 387 of the Companies Act). Resolution on the aggregate or maximum amount to be paid to all directors is sufficient, and the actual amount to be allocated to each director may be left to the decision of the board of directors (according to a judicial precedent. Please note, however, that information on compensation for outside directors needs to be distinguished from that for other directors in reference documents. (Article 82 of the Ministerial Ordinance for Enforcement of the Companies Act)

Therefore, resolutions relating to the establishment of executive compensation plans include: (i) resolutions on contents of the agendum to be proposed to a general meeting of shareholders (Article 298, Paragraph 1, Item 5 and Paragraph 4 of the Companies Act, and Article 63, Item 7 of the Ministerial Ordinance for Enforcement of the Companies Act) and (ii) resolutions on allocation of compensation when actual allocation to each director is entrusted by the meeting of general shareholders to the board of directors. The explanations provided here will focus primarily on the latter.

Please note that with respect to a director who holds concurrent posts as an employee and a director, the compensation for such individual's duties as an employee is treated differently from executive compensation according to a judicial precedent.

(b) Significance of Executive Compensation

The design of an executive compensation plan affects the whole management of the company.

For instance, an executive compensation plan in which the ratio of fixed compensation is high is expected to prevent the management from taking excessive risks, and thereby avoid impairment of corporate value. Conversely, if it is stipulated that the annual aggregate amount of compensation for executive directors shall be 0.5% of the consolidated sales amount for the latest fiscal year, the whole company is likely to work together to expand the consolidated sales amount.

Therefore, a prudent approach is necessary if the management policy and the executive compensation plan does not seem to match.

If a company with a sales-linked compensation plan, such as the one mentioned above, aims at cost cutbacks and focuses on core businesses in its business plan, directors are forced to conduct the company’s business for cutbacks of their compensation. As a familiar example, we are concerned that in a company that only pays fixed compensation for the long term, it is impossible for an executive to receive appropriate compensation even if he/she attempted to pursue a new business

and accomplished significant performance therein, while they are still held responsible for failure of a new business by being dismissed or demoted.

Since executive directors have an obvious interest in the executive compensation plan, they hesitate to express opinions on it. Therefore, even a person of high-integrity is likely to avoid giving careful consideration to the compensation plan, or to opt for easier actions such as following customary practices and leaving decisions on the compensation plan to the CEO.

Independent Directors/Auditors, in their role of expressing relatively objective opinions, are expected to propose certain ideas on the design of the compensation plan that would bring it in line with the management issues of the company.

Executive compensation plans are important from the viewpoint of controlling costs caused by the separation of ownership and management of the company, as well as the viewpoint of the company's management. Resolutions relating to executive compensation are an issue that brings the interests of the management and shareholders into sharp conflict, in that the portion to be distributed to shareholders decreases according to the amount of executive compensation to be paid. We note, however, it is also an opportunity to align the interests of the management and shareholders through the adoption of stock options or stock-price-linked compensation. The agendum for establishment of an executive compensation plan is important enough to require the careful attention of Independent Directors/Auditors who represent general shareholders.

Compensation of one hundred million yen or more is required to be disclosed under the Financial Instruments and Exchange Act, and needs to meet detailed requirements in order to be treated as an expense for tax purposes. Independent Directors/Auditors are not required to directly confirm the satisfaction of such requirements, but it would be helpful for them to confirm whether someone with professional knowledge has examined it.

(c) Recent Trends

Excessive risk taking behavior using complicated financial instruments has been considered one of the causes of financial crisis triggered by the bankruptcy of Lehman Brothers, the U.S. investment bank, in 2008. It is also indicated that the design of executive compensation plans in the U.S. motivate such risk taking behavior. In the U.S., escalation of executive compensation drew public attention, which leaded to introduction of a "say on pay" system which allows a general meeting of shareholders to express their approval or disapproval on non-binding resolutions for executive compensations. As a result, the executive compensation plan of Citi Group was voted down (covered by the evening paper of Nihon Keizai Shimbun, April 18, 2012).

Since in Japan a large portion of executive compensation is paid in the form of fixed compensation and the aggregate amount of executive compensation is low, the issues mentioned above are generally not applicable. Rather, it is indicated as a problem that the portion of fixed

compensation is so high that compensation plans in Japan may have little link to interests of shareholders. Since the preferable design of compensation plans varies depending on the situation surrounding each company, such as the type of its businesses, trends in competition, future business plans, qualification of its directors/auditors, and taxation systems, we are not able to uniformly discuss it in terms of the average Japanese company or standards for U.S. companies. It would, however, be helpful for us to consider trends in discussions on the topic.

For instance, stock options as stock-price-linked compensation are highly connected to the interests of shareholders, while it may motivate the pursuit of short-term interests if such options are immediately able to be exercised. Implementation of such stock options invites criticism of forgetting the lessons of Lehman's fall in the U.S.

(d) Compensation Plan for Independent Directors/Auditor

The compensation plan for Independent Directors/Auditors should not be such that it would impair their independence.

If an Independent Director/Auditor obtains all their income from their compensation as an Independent Director/Auditor, it is not too much to say that such compensation itself causes a loss of independence. Even if it is not applicable, receipt of too much compensation may lead to a situation where the Independent Director/Auditor in question is likely to avoid going against the executives including CEO due to an excessive fear of losing such compensation.

Meanwhile, it is difficult for Independent Directors/Auditors to perform their duties without compensation which reflects their efforts or contribution. If the weight of their responsibilities is not appropriately valued, it is a problem.

Substitutability, in which we consider how much compensation the Independent Director/Auditor in question may obtain if he/she resigns as an Independent Director/Auditor and spend all of his/her efforts contributed to the company as Independent Director/Auditor for other businesses, is one of keys to judging the appropriateness of compensation, but it is still too vague.

It is a difficult issue, but we must seek a certain level of compensation that will not impair the independence of Independent Directors/Auditors, which is also sufficient as an incentive for performing their duties.

There are various opinions on receipt of business-performance-linked compensation by Independent Directors/Auditors. In particular, some people consider that paying business-performance-linked compensation to Independent Auditors is not legally permissible. With respect to an outside director as Independent Director as well, if we take a stance that enhancement of the business performance of a company is traded-off against compliance, adopting business-performance-linked compensation system for Independent Director seems likely to be inconsistent with the stance.

If we believe that an outside director serving as an Independent Director is expected to contribute to the enhancement of business performance by providing his/her knowledge and experiences to the company, and such function is not traded off against the enhancement of business performance, there is not any problem with adopting a business-performance-linked compensation plan for such Independent Director.

In addition to the above, in accordance with the expected role of Independent Directors/Auditors of contributing to the protection of the interests of general shareholders, certain indexes that conform to the interests of long-term holding shareholders such as return on equity (ROE) may be used for the compensation of Independent Directors/Auditors.

Being a plan permissible under the relevant laws is the minimum requirement. We need to carefully consider, when introducing business-performance-linked compensation, whether the company is criticized for its directors/auditors overlooking a corporate scandal due to fear of losing such business-performance-linked compensation even if they were unable to prevent it from occurring, as well as the ratio of the fixed portion and business-performance-linked portion of their compensation.

List of references

Tanabe and Partners, et al., Legal practice, accounting practice and tax practice relating to Executive Compensation Plan, (Seibunsha, 2012)

Takeyuki Ishida, *ISS Proxy Voting Policy 2012*, 1960 Junkan Shojihomu, 46 (2012)

Tetsu Aizawa, et al., Commentaries on issues, New Companies Act, (Shojihomu, 2006)

4. Establishment of Managerial Target and Performance Report

OUTLINE OF AGENDUM

Details are mentioned in the material separately attached (the following is an excerpt).

i) Medium-term Business Plan, Profit Plan for Current Business Term

Example	FY 2012 (Current term)	FY 2013	FY 2014	FY 2015
Amount of Sales	100	200	300	400
Operating Income	5	15	30	50

ii) Performance Report (Monthly Results, Quarterly Results and Full-year Business Results)

Balance Sheet, Statement of Profits and Losses and Cash-flow Statement

ISSUES ON AGENDUM

i) There is no awareness of the cost of capital when establishing the Business Plan.

ii) The basis for increase in profit and sales is not provided, and we are not able to confirm whether assumptions for the plan are reasonable.

iii) Because no qualitative explanation is given on the performance report, and the referential materials include only the information on this year and thereafter, we are unable to compare with the past, or understand/evaluate the progress on the budget.

VIEWPOINT OF GENERAL SHAREHOLDERS

General shareholders expect the management to establish a business plan that demonstrates an awareness of the expected rate of return (cost of capital). The interests of general shareholders may be rephrased as the pure interests of the company, and thus incorporating such viewpoint is useful for business judgment in many cases.

Independent Directors/Auditors are expected to provide the board of directors with the viewpoint of general shareholders. The financial department or investor relation department of a company often holds the information necessary for the viewpoint of general shareholders. It may be useful for Independent Directors/Auditors to utilize the knowledge of such departments.

CHECKLIST

☑ The business plan is established with a reasonable basis.

- △: Simple stories to accomplish such plan are described without deep discussion on feasibility.
- ◎: Making comparison with other cases and using empirical data, the management discusses the establishment of the plan based on its feasibility and the expected performance of the plan.

☑ The management policy demonstrates an awareness of the enhancement of corporate value.

- △: The management pays attention only to the profits and losses of the company. If profits are generated, it satisfies the management.
- ○: The meaning and significance of the cost of capital is commonly understood, and certain benchmarks such as ROE are used for decision making.
- ◎: Certain benchmarks such as ROE are made publicly available and used for communication with general shareholders or investors.

☑ The performance report is utilized for future business judgment.

- △: It is considered a mere report on performance. There is little link between contents of the performance report and future business decisions.
- ○: Comparative analysis with the past and progress on budget, and the feasibility of managerial targets based thereon are mentioned in referential materials.
- ◎: Based on comparisons with the past and feasibility, minor amendments are made to the plan from time to time. The performance report functions well as the “C” of the PDCA (plan-do-check-act) cycle.

COMMENTARIES

(a) Necessity of Cost of Capital Awareness

As discussed in the General Discussion section, corporate activities of listed companies mainly aim at continuous growth and enhancement of corporate value. Stakeholders of a listed company range from its executives and employees and the family members thereof to other members of the corporate group, client companies, financing bank, customers, local communities and the government. If the management focuses attention on shareholders that may receive benefits only through the enhancement of corporate value, it will reach a management policy that conforms to the pure profit of the company. Needless to say, it is not such a simple problem that the company may establish a plan by paying attention only to general shareholders. At a minimum, the management should examine matters from the viewpoint of general shareholders, whether the company is able to make a profit which exceeds the cost of capital, and then establish the plan.

However, listed companies do not always give consideration to this viewpoint upon establishing business plans in actuality. For example, many listed companies target simply "X% increase in profit from the previous year," which is a simple year-on-year figure goal with no consideration given to the cost of capital.

From the viewpoint of the enhancement of corporate value, it is important for the company to enhance its profitability while being conscious of cost of capital.

The basis for corporate activities is to raise funds in some form, and to generate profits with such funds. As methods for such fund raising, bank financing or receiving funds from shareholders by issuing shares of the company's stock are possible in addition to using cash reserves. When we consider the cost for such fund raising, in the case of bank financing, we need to pay back the funds plus interests, and such interest is cost. In the case of fund raising by issuance of new shares, we do not need to pay the contributed funds back. No interest accrues either.

However, the funds contributed by shareholders incur a certain cost of capital as well. Investors have options for investment other than stocks, and among them there are products from which certain rate of return can be expected, such as government bonds or fixed term deposits. If a shareholder invests in shares of a company's stock, he will lose the opportunity to obtain such rate of return. Therefore, from the viewpoint of shareholders, obtaining a certain profit from the investment in shares is not enough. The profit generated from such investment is expected to be at least over the rate of return mentioned above. Such expected return is the cost of capital (cost of equity). The point of concern for shareholders is whether their investment will generate more profit than the expected return (see General Discussion section, paragraph 3 "Questions and Answers on Independent Directors/Auditors").

If companies aim to carry out business so that long-term shareholders may obtain returns worth their investments, value worth the capital entrusted by shareholders will be created.

Independent Directors/Auditors, who are expected "to make efforts to have business decisions made with the viewpoint of general shareholders in mind," are required to ask questions from the viewpoint of whether managerial target setting by the company exceeds the expected cost of capital, and to provide the management with opportunities to start exercising management with an awareness of the cost of capital.

(b) Communication with Shareholders/Investors

Since managerial targets are extraordinary important for investment decisions, they should be made available to shareholders and investors and be utilized for communication between the company and shareholders/investors. If there is any gap between the measures used by the company and those by shareholders/investors, communication between them does not go well. It is important for the company to understand the viewpoint of shareholders/investors.

One of the benchmarks shareholders often use to estimate corporate value is ROE. ROE is calculated as "Net Income divided by Shareholders' Equity," and measures how much profit a company generates with shareholders' equity.

According to the result of a survey conducted by the Life Insurance Association of Japan in fiscal year 2011, 82.3% of the institutional investors on which the questionnaire survey was conducted referred to ROE as the business benchmark that they wanted the company to make public in the medium-term business plan, which explains how shareholders weigh heavily on ROE.

Meanwhile, only 32.8% of listed companies published their ROE in their medium-term business plans. There is a significant gap between the demands of investors and the actual implementation status by listed companies.

Needless to say, ROE is not the sole benchmark for companies' business. There are other benchmarks that shareholders/investors heavily weigh as measures for corporate value. Which benchmark a company should use for communication with shareholders may vary depending on the business model of the company. Independent Directors/Auditors are expected to ask for active communication between the management and shareholders through managerial target setting appropriate for the company.

The results of a survey conducted by the Life Insurance Association of Japan in fiscal year 2011 indicate that investors want companies to provide more detailed explanations in medium-term business plans and hold briefing sessions for management policy or management strategy as efforts

to further enrich communications with shareholders. It is a reality that not many companies try to make such efforts, although many of them are aware of such requests. It may be possible for Independent Directors/Auditors to propose the management hold such briefing sessions to share the relevant managerial targets with shareholders.

(c) Confirmation of reasonableness of Business Plan

Even if the company establishes a business plan that would exceed the cost of capital, we should pay attention to whether the basis for such plan is reasonable.

For instance, as described in the "*OUTLINE OF AGENDUM*" at the beginning, the amount of sales is assumed to increase by double or triple annually. We, however, need to examine the reasonable basis for such rate of increase. If the industry field does not change much and the company does not change its business strategy, it is impossible for the company to double its sales as projected in the plan without extraordinary circumstances. The profit margin is also assumed to improve annually. It is, however, impossible for the company to have its profit ratio sharply improved without changing its operations. An unreasonable business plan misleads investors/shareholders significantly, and is inappropriate. Meanwhile, if the company establishes a plan which is too conservative to dramatize the growth exceeding the expectation, it is also misleading. Actual performance rarely matches the figures in the plan, and the difference between actual performance and the plan itself is not a problem. It is necessary for the company to establish a business plan based on appropriate assumptions and a reasonable foundation, based on the circumstances surrounding the company and actual conditions.

The process for establishing a business plan varies for each company. Usually, the business plan of a company is established by accommodating the figures targeted by the management and the figures set by each business department reflecting actual conditions. Even if the management targets a high figure, it is meaningless if such figures are infeasible, and if each business department sets targets too conservatively, such targets may be inappropriate.

Independent Directors/Auditors are required to actively request the management's explanation on the process of establishing the plan and the assumptions for the plan in order to confirm the reasonableness of the plan from an objective viewpoint.

(d) Performance Report as the C of PDCA

From the viewpoint of business management, it is important for the company to implement the PDCA cycle appropriately. The performance report at a meeting of the board of directors works as a C (check). Under the Companies Act, the management is required to make a report on businesses at least every three months (Article 363, Paragraph 2 of the Companies Act), while in many listed companies such reports on businesses are made every month as scheduled.

The format of materials for performance reports vary by company, and it may even vary depending on the length of the period for which the report is made, be it monthly report, quarterly report or annual results report. The purpose of the report also varies depending on the period for which the report is made. Regardless of the period for which the report is made, what is important here is whether enough information is included in the materials to appropriately fulfill the purpose of the report, so that the performance report may serve as a check of the managerial target.

For instance, there are cases where only the statement on profits and losses, balance sheet, statement on cash-flow and statement on cash receipts and disbursement are attached as materials for the board of directors, and the report is made only by repeating the contents of such materials. With only such report, the board of directors will have difficulty appropriately fulfilling checking functions, such as evaluation of actual performance, confirmation of progress on managerial targets, and consideration of future strategy.

As for evaluation of performance, the board may be able to analyze what actions are taken and what figures are generated as a result of such actions using methods such as comparisons with past results. As for the progress on managerial targets, the board needs to analyze the difference between the monthly performance or quarterly performance and the target (budget) and, if the performance falls short of the target, the reasons why.

Further, the board needs to grasp how the annual or mid-term target figures change based on the accumulated performance. If it is proved that the managerial target already announced is difficult to be attained, the company needs to change such target figures. We note that under the timely disclosure rules of stock exchanges, a listed company is required to conduct disclosure in a timely manner if the information on future projections is revised to some extent, such as a revision of 10% or more to sales amounts or a revision of 30% or more to profits.

It is an important role of Independent Directors/Auditors to confirm whether the information necessary for examination from the viewpoint mentioned above is appropriately provided in the materials of the performance report, and if not, to ask for the improvement of the materials.

List of references

Yuki Kimura & Ryohei Yanagi, Practice of Corporate Finance (Chuo-keizai-sha, 2011)

5. Starting New Business

OUTLINE OF AGENDUM

As decided by a management meeting based on the market research and analysis shown in the separate materials, the Company will establish a new business department as follows:

Name of Business Department:	XX Department
Personnel Positioning:	General Manager: Mr. XX (for other members, see exhibit 1)
Budget Plan:	Initial budget: XX yen XX yen/year thereafter (up to XX yen in total)
Business Plan	See Exhibit 2 (the following items are excerpts) - To become profitable within approximately 3 years - To eliminate accumulated deficit within 7 years at the latest

ISSUES ON AGENDUM

i) Discussion on why entry into the new business was left to the management meeting, and only the results of such discussion were given. Details of such discussion are unknown.

ii) Time value of cash was not taken into consideration, and the concept of cost of capital was not reflected.

VIEWPOINT OF GENERAL SHAREHOLDERS

For general shareholders, whether they can obtain a profit more than the expected rate of return is the line separating success and failure of the investment in question. Even if the project is profitable, if such profit is below the expected rate of return (cost of capital), such project is a failure from the viewpoint of general shareholders. This is not because general shareholders are greedy. The same is applicable to the company. It is possible to not be in the red by simply making deposits with a bank.

Independent Directors/Auditors are expected to bring the viewpoint of general shareholders into discussion at the board of directors, and confirm whether new businesses are accountable from the viewpoint of the expected rate of return.

CHECKLIST

☑ The concept of cost of capital is taken into consideration for entry into a new business.

- △: Accumulation of experience and know-how is overvalued and no one considers withdrawal from such business even if the business is not meeting expectations.
- ○: The benchmarks necessary for the management to evaluate new businesses from the viewpoint of cost of capital, such as Internal rate of return (IRR) and net present value (NPV) of new businesses, are provided to the board of directors.
- ◎: The company has certain criteria for making investments in or withdrawals from businesses which is based on the concept of cost of capital. The management makes a comparative review of various options including investment in the existing businesses, paying attention to how the market evaluates entry into the new business.

COMMENTARIES

(a) Necessity of Investment Policy

In corporate activities, it is important for the company to choose investments for enhancing corporate value as much as possible, and then actively make investments for the future. Because of the limitations of management resources, investments that the company may make are automatically limited and the company must decide priority of investments and needs to exclude investments that are unlikely to generate any corporate value. Therefore, the company needs to maintain a certain investment policy. In order for a company to grow or to generate corporate value, the company needs to make investments. It is, however, important for the company to examine its investment policy from the viewpoint of the limitations of management resources and the exclusion of investments likely to impair corporate value.

There are various criteria that companies usually consider when making investment. The criteria that Japanese listed companies have historically used focus on "when the project will become profitable" or "how long it will take the company to collect the funds invested."

We note, however, that the viewpoint of the cost of capital is necessary for the interests of general shareholders, i.e., for the pure profit of the company. In the budget for capital expenditure, the company is required to be aware of the principle "a company may create corporate value, only when it generates returns which are greater than the cost of capital." Some Japanese companies are unaware of the cost of capital, as often criticized by investors. This sometimes causes misunderstandings and friction in the communications between a company and its investors. Independent Directors/Auditors are expected to contribute to filling such gap.

(b) Cost of Capital-Conscious Investment Policy

If the company considers introducing a "cost of capital-conscious policy," NPV (net present value) and IRR (internal rate of return) would be helpful. It is said that at least in the past NPV and IRR were not used as much as the payback period method in the budget of capital expenditure.

NPV and IRR that are based on the present value of cash flow reflecting the cost of capital are more important for the creation of corporate value than income/profit for accounting purposes or the period for collecting invested funds (they are also important, though). Assuming that management resources are unlimited, the following rules are fundamental forms.

NPV RULE

i) Investment in a project should be accepted, if its NPV is a positive figure.

ii) Investment in a project should be rejected, if its NPV is a negative figure.

IRR RULE

i) Investment in a project should be accepted, if IRR on the project is greater than the discount rate.

(ii) Investment in a project should be rejected, if IRR on the project is less than the discount rate.

For a strict definition of terms, please refer to a technical book, but NPV means future cash flow from a new business discounted to arrive at the present value minus the amount of initial investment. To rephrase, this means that NPV shows how much the invested funds increase. If NPV of the investment is a positive figure, corporate value is also created from the viewpoint of general shareholders.

IRR means the rate of return from the investment. IRR works as an investment policy by being compared with the discount rate as the minimum expected return. In this context we mean the cost of capital by the discount rate.

Either of the above mentioned investment policies can be used to determine whether the returns from the investment are more than the cost of capital. We can say that these policies represent the same idea in different forms.

The features of these investment policies are that (i) they evaluate profits so as to reflect time value, and (ii) even if the project in question is profitable for accounting purposes, it does not allow the company to make investments in the project unless such investment creates value which surpasses the cost of capital.

Neither of them is taken into consideration in the traditional approaches of "when the project becomes profitable" or "how long it takes for the company to collect the funds invested."

There is room, however, for the company's arbitrary manipulation in calculating the cost of capital or estimating the growth of future cash flows. Independent Directors/Auditors are not expected to calculate these figures themselves. They are, however, expected to confirm with the person in charge depending on the situation whether the basis for calculation is reasonable, and to pay attention to how NPV is affected by changes in uncertainties and the investment decisions are affected.

(c) Relation to Cost of Capital of Company's Overall Business

Since management resources are limited, a certain project's satisfaction of investment policy reflecting the concept of cost of capital does not necessarily mean a green light for such project. The company needs to consider whether there are more preferable projects in which to invest, and from the viewpoint of usage of surplus the company may think about reinvestment in the

existing businesses or enhancing capital efficiency by conducting measures for shareholder return such as acquisition and cancellation of treasury stocks or dividends.

Even if NPV on a certain project is calculated as zero, such project may significantly benefit the company in fostering human resources or accumulating know-how, which cannot be reflected in the calculation of NPV. Someone may consider that such benefits lead to the creation of future cash flows or the enhancement of corporate value. However, as long as a company is managed using the funds contributed by general shareholders through the capital market, it needs to make decisions in consideration of the viewpoints of the cost of capital and capital efficiency. Independent Directors/Auditors are expected to understand the viewpoint as a whole, confirm the management's attitude on future targets or improvement measures if necessary, and be prepared to provide general shareholders with logical explanations.

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6. Business Restructuring including M&A

OUTLINE OF AGENDUM

The Company enters into an agreement with Company XXX, non-listed company, as of MM DD, YYYY to acquire XXX business of Company XXX in consideration for XXX yen, for the purpose of entry into a new XXX business.

ISSUES ON AGENDUM

i) Explanation of the purpose of entry into the new business or the contents of the new business is insufficient.
ii) The method of acquisition is not clarified.
iii) The scale of consideration for this business acquisition and the calculation basis are not clarified.
iv) Projections after entry into new business are not sufficiently explained.

VIEWPOINT OF GENERAL SHAREHOLDERS

Many of the issues discussed in "Starting New Business" are applicable to M&A transactions, while in M&A transactions, synergy of the existing business and the target, and the premium to be paid by the acquirer require special attention.

We note that there are varieties of methods for M&A transactions, and the effect may vary depending on the method to be taken. Not only the amount of time, tax consequence and approval and license of businesses, but also the existence or non-existence of appraisal rights of shareholders that would directly affect interests of general shareholders is included in differences caused by the methods.

The expected role of Independent Directors/Auditors may vary depending on whether such Independent Directors/Auditors represent the interests of general shareholders of the acquiring company or the target company. We note however that the basis is the same.

CHECKLIST

☑ Discussion is conducted by the management with their understanding of features of the M&A transaction.

△: Driving power for the M&A transaction is lock-step mentality with a competitor that implemented an M&A transaction. Implementing an M&A itself is considered a goal regardless of contents of the M&A transaction. The company has indicated the synergy effect of the transaction, but no concrete explanation is given.

○: The company prudently examines the cost and synergy of the M&A transaction, and calculates target figures or projections before their judgment. Comparative review among other options is made from the viewpoint of whether the M&A transaction contributes to the enhancement of corporate value.

☑ The management pays certain attention to the methods of the M&A transaction.

△: Although the scale of the M&A transaction is so large that it is likely to significantly affect the company's fate, the management expresses their concern only on whether or not to implement it, while they show little concern for what method of M&A should be used to implement such transaction.

○: The management understands the main features of the possible M&A methods, and discuss it, although details are left to the professionals and the person in charge of the transaction.

COMMENTARIES

(a) What is M&A?

M&A means merger and acquisition and we use this term to collectively mean mergers with other entities or acquisitions of shares of another company or assets.

M&A is used as a method for expansion of existing business or entry into new businesses, reorganization of corporate groups or business succession. Here, we cover entry into new businesses.

For instance, we assume that there is a company that considers entry into a new business because of the weakness of its existing businesses. The company may raise funds necessary for new businesses and newly establish manufacturing capabilities such as factories or sales networks from scratch. This will take a great amount of time, and no one knows whether such establishment leads to the enhancement of performance because there is no background for projection. If the company acquires the existing businesses of others, the company may obtain manufacturing capabilities, sales networks, know-how, or personnel familiar with such businesses in a short period of time, which means the company may participate in the new business for a short period and with low risk. This is one of the functions of M&A.

There are cases where the target of the acquisition is business assets themselves, as is the case with the acquisition of a business or corporate split, while there are cases where the target is shares of the target company's stock, as is a case with the assignment of stock or a share exchange. The consideration to be paid by the acquiring company in such cases includes cash and stock of the acquiring company.

If the consideration to be paid by the acquiring company is stocks, no cash will be drained from the acquiring company except for various expenses, while it will cause changes in the shareholders' composition or dilution. If such consideration is cash, the necessary funds may be raised through a loan or covered by internal reserves.

Regardless of the form of M&A, for M&A implemented by a listed company, the viewpoints of whether such M&A leads to the enhancement of corporate value and whether it is profitable enough to exceed the cost of capital are necessary.

(b) M&A and Corporate Value

There are two points we should consider in order to have a certain M&A create value: synergy and premium.

Usually, the purchase price is the current stock price of the target company with the addition of a certain premium. Otherwise, shareholders of the target company would not accept the offer.

In the case of M&A by means of tender offer by cash, it is generally said in the market that the average premium is somewhere between twenty (20) percent and thirty (30) percent. Cash is everything for shareholders of the target company because selling their shares means they are no longer shareholders. Meanwhile, since shareholders of the acquiring company do not prefer payment of such premium, the acquiring company needs to explain that the M&A will generate a certain synergy that justifies the premium.

In cases of merger or share exchange, since shareholders of the target company may have their shares of the company's stock exchanged with shares of the acquiring company's stock, i.e., new company's stock, at a certain proportion, they can enjoy future enhancement of corporate value. If the projections of the new company are positive, the premium will be small. In some cases, the premium is negative, i.e., the discounted consideration case. Shareholders of the target company also need to take on the risk of the new company as its shareholders in both a positive and negative sense.

Regardless of whether the consideration is paid in cash or in stocks, the synergy to be attained by M&A justifies the payment of the premium, which means synergy is important in M&A cases. Without it, there is no reason for two companies to get together. Synergy includes revenue synergy that leads to an increase in sales or profit in positive way, and cost synergy to be attained by restructuring.

We can describe the following formula with respect to the relationship of economic reasonableness of the M&A and Synergy/Premium:

Purchase Price
= Market capitalization + premium compared to the market price
= Intrinsic Value calculated by DCF + substantive premium
= Intrinsic Value calculated by DCF + a part of synergy as a merit to be enjoyed by the target company (Note: the remaining part of the synergy belongs to shareholders of the acquiring company)

Synergy
= Merit to be enjoyed by the target company's shareholders + Merit to be enjoyed by Acquiring Company's shareholders
=Cost Synergy by restructuring + Revenue Synergy such as increase in Sales Amount

Theoretically, M&A is not feasible unless shareholders of the target company and those of the acquiring company may both enjoy benefits, i.e., win-win situation. It is the role of Independent Directors/Auditors to ensure such situation. Independent Directors/Auditors of the target company should confirm whether the purchase price exceeds the intrinsic value of the target company as viewed by the target itself (confirmation of the sale's merit), and those of the acquiring company

should confirm that the purchase price is within the intrinsic value added by feasible synergy (avoidance of overpay).

As stated above, regardless of whether the M&A in question is protective or aggressive, both the acquiring company and target company are required to define and estimate corporate value, synergy and premium and to provide a detailed explanation on corporate value quantitatively based thereon, as the management fiduciary duties to shareholders. Independent Directors/Auditors play a role in securing the creation of corporate value as representatives of general shareholders.

(c) Methods of M&A

Methods of M&A include: mergers, corporate splits, share exchanges, stock transfers, assignments of business (acceptance of assignments of business), and assignments of shares. In implementing M&A, the acquirer is required to have an agreement with the target company or the owner of the target company (such as a merger agreement or stock purchase agreement) approved at a meeting of the board of directors, and in some cases further required to have such agreement be approved at a general meeting of shareholders under the Companies Act. Depending on the size of assets to be delivered as consideration for the acquisition, the controlling relationship between the acquiring company and the target company, and the method of M&A, a resolution of a general meeting of shareholders is not required in some cases.

Which methods should be used for M&A may vary depending on the purpose of the M&A in question. There are a variety of options: if the acquiring company intends to acquire the businesses of the target company and business assets related to a portion of businesses are the target, the assignment of business or corporate split are options; if the acquiring company intends to make the target company its subsidiary, a share transfer or the assignment of shares are options; and if the acquiring company intends to take in the target company, the option of a merger is available. The required process, or accounting or tax consequence will vary depending on which method is chosen. The intention of, or request from the target company and its owner should be considered, as well as the purpose of the acquiring company. The method most appropriate for the purpose of the M&A should be chosen after taking various issues into consideration.

The basic contents of a merger or acquisition are provided for in the agreement entered into between the acquiring company and the target company or its owner. Since the contents of such agreement are mostly fixed through negotiation with the counterparties thereto before being proposed to the board of directors, it is advisable for Independent Directors/Auditors to receive an explanation from the management on the process of such negotiation, and confirm whether the merits and risks of the transaction have been reasonably estimated.

(d) Estimation of Corporate Value

Upon the implementation of M&A, practically the most important thing is the level at which the target should be estimated. Since the number of shares or the amount of cash to be paid as consideration by the acquiring company depends on how much value is estimated for the businesses or shares of the target company, which is reflected to the purchase price, such estimation significantly affects the interests of shareholders of the acquiring company as well.

The process to be taken for estimation of corporate value is due diligence. Professionals such as consulting firms, auditing firms, and law firms conduct investigations on the target company or its businesses from business, financial, and legal viewpoints in order to understand the various issues involved in the transaction. If certain facts that may cause unexpected debt or legal risk such as lawsuits are found, these are reflected in the terms and conditions of the agreement or the purchase price or merger/exchange ratio. In addition, by understanding the involved issues in advance, the acquiring company may have such issues solved before implementation of the acquisition.

Therefore Independent Directors/Auditors need to confirm whether due diligence for the transaction in question has been appropriately conducted at the time of decision making for implementation of the acquisition. The results of each report should be examined at the board of directors.

When deciding the actual purchase price or the merger/exchange rate, it is usual that the company asks an independent calculation agent that is independent of both the acquiring company and the target company (in many cases, a securities company or auditing firm is in charge of this) to calculate the purchase price or merger/exchange rate. The independent calculation agent estimates the corporate value using a calculation method of corporate value based on the results of the aforementioned due diligence. There are varieties of calculation methods for corporate value. In cases where an acquisition is implemented for positive management strategy, such acquisition is expected to have a multiplier effect, i.e., expected to generate a synergetic effect. If that is applicable, typically the following methods are used for calculation: (i) the method in which corporate value is calculated using future cash flow generated by the target company or the businesses thereof based on the profit plan for a certain period; or (ii) the method in which corporate value is calculated using net assets, Sales, operating profit, net income and the like of the target company.

Actual price or exchange/merger ratio will be decided upon agreement between the acquiring company and the target company or its owner based on the result of the above mentioned calculation. Although the negotiation and agreement therefor are eventually left to the business judgment of the management, for the acquiring company the result should not be unfairly high and far from the actual corporate value. When examining the price or ratio, Independent Directors/Auditors are required to confirm the reasons for the final price or ratio, based on the

contents of the business plan that is used as the basis for calculation and the calculation report made by the independent calculation agent, and (depending on each case) the cost of integration.

We note that under the rules of stock exchanges, when a listed company conducts a merger, company split, share exchange or share transfer, it must disclose such fact in a timely manner regardless of size of the transaction. The calculation basis for consideration of the transaction must be included in such disclosure documents and be made available to shareholders.

List of references

Kunio Ito, Seminar on Evaluation of Corporate Value (Nihon Keizai Shimbun Shuppansha, 2007)

Yuji Tanaka, Evaluation of investment value and investment decision in M&A transactions (Chuou-keizai-sha, 2012)

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7. Takeover Defense Measures

OUTLINE OF AGENDUM

Subject to approval at the XXth ordinary general meeting of shareholders scheduled for MM DD this year, the company introduces the following measure against (i) the acquisition of the company's stock in which the acquirer intends to increase its voting ratio to more than twenty (20) percent, or (ii) the acquisition of the company's stock that results in the acquirer's voting ratio being twenty (20) percent or more.

Type:	Pre-warning defense measures
Actual contents:	Establishing rules for large-scale acquisition (see the supplement for details) Defense measures against a situation where the rule is violated (see the supplement for details)

ISSUES ON AGENDUM

i) Explanation on reasonableness of takeover defense measures is missing.

ii) The company's attitude toward such measures' influence on shareholders/investors should be clarified.

VIEWPOINT OF GENERAL SHAREHOLDERS

Takeover defense measures originally intend to protect the interests of shareholders from proposals of acquisitions that are likely to jeopardize corporate value. If such takeover defense measures are abused for the protection of the management, it may block an acquisition preferable to general shareholders.

Independent Directors/Auditors of the target company are required to supervise or monitor from the viewpoint of general shareholders whether the management appropriately examines the pros and cons of the introduction of the takeover defense measures and (when such measures are actually implemented) whether they utilize such measures in accordance with the purpose of their introduction.

CHECKLIST

☑ The management considers the introduction of takeover defense measures, having understood significance of the measure.

△: The management misunderstands that takeover defense measures are a mechanism for the protection of the management from a proposal of hostile acquisition. The management arbitrarily expands the meaning of corporate value, and considers that a proposal for acquisition requiring a change in the current management impairs corporate value.

○: The management understands takeover defense measures are a tool that helps the management gain acquisition proposals which are more preferable to shareholders, and designs the measures so. The company confirms the intentions of shareholders upon introducing the measures.

☑ No arbitrary operation is conducted in relation to implementation of takeover defensive measures.

△: For a proposal that requires a change in the current management, the management has reached the conclusion that takeover defense measures will be implemented. The management is doing so-called “opinion shopping” with respect to opinions from independent persons or professionals.

○: (Assuming the design of takeover defense measures is appropriate) The Company takes the prescribed steps to achieve the design purpose of the measures in a methodical manner. The company pays attention to fairness in appearance as well as the actual fairness of the operation.

COMMENTARIES

(a) What are Takeover Defense Measures?

Takeover defense measures include various concepts. In accordance with the "Guidelines Regarding Takeover Defense for the Purposes of Protection and Enhancement of Corporate Value and Shareholders' Common Interests" by the Ministry of Economy, Trade and Industry and Ministry of Justice (the "Guideline"), takeover defense measures refer to "measures adopted by a joint-stock corporation prior to the making of an unsolicited takeover proposal, such as the issuance of shares or stock acquisition rights (*Shinkabu Yoyakuken*) for purposes other than business purposes such as fundraising, which are intended to make it difficult to accomplish a takeover that is not approved by the board of directors." This section uses such definition as well.

Typical examples of takeover defense measures are: pre-warning defense measures and trust-type rights plans. The former is a measure where the company formulates the rules applicable to a large-sized acquisition in advance, and if the hostile acquirer violates such rules or the proposal of such acquirer itself is likely to jeopardize corporate value, the company actually takes defense measures by, for instance, issuing acquisition rights of the company's stock to its shareholders without any consideration (such acquisition rights are designed so that the hostile acquirer may not able to exercise them). The latter is a measure where in addition to the pre-warning mechanism, the company trusts the share acquisition rights of the company's stock with a trust bank in advance, and if a hostile acquirer who violates the acquisition rules appears, such trusted acquisition rights of the company's stock will be distributed to shareholders. Either measure, if implemented, will cause dilution of shareholdings or the issuable shareholding ratio of the hostile acquirer, which means the hostile acquirer needs to acquire more of the company's stocks, and the purpose of the acquisition becomes unlikely to be attained.

(b) Matters to be considered relating to Takeover Defense Measures

Takeover defense measures serve the function of protecting shareholders from impairment of corporate value caused by certain acquisitions or proposals thereof, while it may lead to the company infringing upon the principle of shareholder equality by exercising different treatment among shareholders and it may jeopardize shareholders' common interests by rejecting proposals of acquisitions that are in fact preferable to the company for the self-protection of the management.

In the past, because some companies reflected "corporate value" as vague and inestimable concepts (for example, corporate culture, sentiment of employees and relationship with local communities) in takeover defense measures, general shareholders' rights to sell their shares in such companies were threatened regardless of the purchase price.

If the management is allowed to arbitrarily define corporate value and to claim that any proposal for acquisition is likely to jeopardize its inestimable corporate value, takeover defense measures will be used for the management entrenchment and may allow the management to exclude even proposals for acquisition which contribute to shareholders' common interests.

Therefore, takeover defense measures should be necessary and proportionate, and the implementation of such measures should not be decided arbitrarily by the management, and an objective examination process regarding the proposal's contribution to the enhancement of corporate value and shareholders' interests should be prepared.

With respect to decisions on the introduction of takeover defense measures or decisions on continuing to have such measures, we can divide cases into three categories: (i) cases where the decision is made by the board of directors; (ii) cases where the decision is made by an ordinary resolution of a general meeting of shareholders; and (iii) cases where the decision is made by a special resolution of a general meeting of shareholders. In many cases, such decision is proposed to a general meeting of shareholders. Although there are cases where a company may introduce or continue to have takeover defense measures without a resolution of a general meeting of shareholders, decisions made only by board resolution are highly criticized by investors. It is preferable for the company to confirm the intention of shareholders when introducing or continuing takeover defense measures.

(c) Role of Independent Directors/Auditors for Implementation of Measures

With respect to decisions on implementation of defensive measures, we can divide the cases into four categories: (i) implementation is decided only by the board of directors; (ii) the independent committee makes recommendation relating to implementation, (iii) intention of shareholders is confirmed by resolution of a general meeting of shareholders or shareholders voting; and (iv) recommendation by independent committee and confirmation of shareholders' intention are both used.

In some case, the independent committee is composed of professionals outside the company such as an attorney at law or accountant.

As is stated in the Guideline mentioned above, "If provisions are included that give weight to the judgments of independent outside directors and auditors (independent outsiders) who are capable of closely monitoring any entrenchment behavior of inside directors, this should be effective in creating confidence among shareholders and the investment community that the decisions of the board of directors are fair. " Independent Directors/Auditors who understand the businesses of the listed company and are highly independent of the management are appropriate to serve on the independent committee. Also, the independent committee functions as a place where Independent Directors/Auditors can truly play their expected roles of protecting general shareholders' interests.

The actual process for decisions on implementing the measures vary for each listed company. Independent committees, upon request from the board of directors, generally examine whether an acquisition by hostile acquirer follows the prescribed rules of large-scale acquisition and whether defense measures should be implemented against such large-scale acquisition, and make recommendations to the board of directors on whether or not the company should implement defense measures.

Therefore, when a hostile acquirer of a listed company appears, Independent Directors/Auditors of the company objectively examine the proposal of the acquirer as members of the independent committee without being affected by the intentions of the management. Independent Directors/Auditors are required to obtain the information or materials necessary for such examination from the board of directors and to determine whether the proposal truly contributes to the enhancement of corporate value or preservation or enhancement of shareholders' common interests, which includes making direct or indirect contact with the acquirer for discussion or negotiation if necessary.

List of references

Trend of Takeover Defense Measures and Analysis of Actual Examples – Actual Examples of General Shareholder Meetings Held in June 2010, 357 Bessatu Shojihomu (Mitsubishi UFJ Trust and Banking Transfer Agent Division ed., 2011)

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8. Fund-raising by Issuance of New Shares, etc.

OUTLINE OF AGENDUM

It is proposed that the company issue new shares by means of third party allotment to a limited partnership for investment as follows:

Number of Shares to be Issued:	XXX shares of Common Stock (5% dilution)
Amount to be Paid-in:	XX yen per share (5% discount from the latest closing price.)
Total Amount to be Paid-in:	XXX yen
Amount of Capital to be Increased:	XXX yen
Amount of Capital Reserve to be Increased:	XXX yen
Date of Payment:	DD MM, 20XX

ISSUES ON AGENDUM

i) Basis for the amount to be funded (basis for the scale of dilution by such new issuance) is not clarified.

ii) It is not clarified how the fund will be used.

iii) Explanation on the calculation basis of the amount to be paid-in is not fully provided.

iv) No information on the third party to which new shares are allotted is provided.

v) It is not clarified why the company chose the method of third party allotment (instead of public offering or rights offering).

VIEWPOINT OF GENERAL SHAREHOLDERS

We recently experienced a series of issuances of new shares in which interests of general shareholders were impaired. Society views insider transactions at the timing of capital increases in particular as an issue. However, there is also the problem that the issuance of new shares is considered to be a cause for lowering the price of shares (an indication for selling). Such situation is driven by the market belief that the so called equity story, i.e., usage of the funds or reasons for the issuance of new shares instead of other funding methods, is not fully explained.

Independent Directors/Auditors are expected to confirm the necessity of fund-raising by means of third party allotment and the basis for the amount to be funded, and to request the management provide an explanation that is acceptable for general shareholders.

CHECKLIST

☑ The board members conduct discussions with significance of the issuance of new shares in mind.

△: The board members see fund-raising by means of third party allotments as a loan that does not require payment of principal and that requires payment of interest only when the company has the money. They thus prefer fund raising by means of third party allotments if possible.

△: It is a common assumption among directors that fund-raising is the domain of the executive officer/executive director in charge of finance. Other directors care very little about fund-raising.

○: It is understood among the board members that the issuance of new shares affects the ratio of debt and equity, and thus affects the capital composition of the company. The issuance of new shares in question is considered a method by which the company pursues the most appropriate capital composition of the company based on its business model.

◎: In addition to the above, the company pays attention to the influence of new share issuance to general shareholders, and the so-called equity story is fully considered and explained.

COMMENTARIES

(a) Significance of Fund-raising by Third Party Allotment

Shareholders may not claim returns from contributed capital, and dividends are not guaranteed. Meanwhile, the residual of the company assets, which is the remaining balance after the deduction of payments to employees or client companies, belong to shareholders, which means the more the company succeeds, the more shareholders obtain profits from the company according to the number of shares they hold.

It is noted that listed companies have issued many shares and the Companies Act requires equal treatment of shareholders according to the number of shares they hold as long as they hold the same kind of stock (Article 109, Paragraph 1 of the Companies Act), which means the more the same kind of stocks are outstanding, the less the value per share tends to be. Company stock buy-backs and cancellations thereof work in an opposite manner, which means they act in the direction of increasing stock prices.

For existing shareholders, emergence of new shareholders via the issuance of new shares is not welcomed as far as there is no change in the company's business.

If, however, contribution by new shareholders and usage of such contributed assets by the company generate profits equal to or more than the existing business, the value per share is not impaired as a result of the issuance of new shares. In this case, existing shareholders have no reason to reject the emergence of new shareholders except for the dilution of their voting rights.

The Companies Act of Japan allows the board of directors of a company to decide the issuance of new shares within the total number of authorized shares without calling for a resolution by a general meeting of shareholders regardless of the usage of the newly invested funds, on the condition that an amount equivalent to the current price of existing shares is contributed for newly issued shares (Article 199, Paragraph 3, and Article 201, Paragraph 3 of the Companies Act).

There exist many companies whose P/B Ratio (Price to Book-value Ratio is equal to the Stock Price divided by Net Assets per Share) is less than one (1). In such cases, even if assets equivalent to the current stock price are contributed, the value per share may decrease. Without new contributions, however, a company may be exposed to the risk of bankruptcy. Thus, it is important for companies to carefully examine how general shareholders recognize such equity finance.

In addition to the above, we note that third party allotments to a particular party are likely to lead to selection of shareholders by the listed company in question. Independent Directors/Auditors must examine the reasonableness of the terms of issuance or size of dilution, from the viewpoint of general shareholders, based on the necessity of the relevant fund-raising, appropriateness of the funds, and reasonableness of the usage of funds.

Especially, with respect to whether the amount to be paid-in is particularly favorable to subscribers for new shares or the reasonableness of the dilution, the rules of stock exchanges

sometimes require listed companies to obtain the opinion of auditors or those who are independent of the management as explained later. Thus, Independent Directors/Auditors need to confirm the contents of the agendum, the reasons or background of the proposal for third party allotment, and the details of discussions on the amount to be paid-in and selection of the third party to which new shares are allotted together with related materials.

(b) Form of Equity Finance

Under the Companies Act, the possible forms of issuance of new shares can be divided into allotments to shareholders and other methods. Most listed companies, however, conduct equity financing such as the issuance of new shares or acquisition rights of new shares by means of methods other than allotments to shareholders such as public offerings or third party allotments.

Public offering is the issuance of shares, etc. by soliciting unspecified number of investors, i.e., fund-raising through the market. In this case, shares, etc. are allotted to an unspecified number of investors at the market price, in principle. Therefore, the influence on the interests of existing shareholders is comparatively small. Public offering, however, is used on the assumption that there is demand for the shares, etc. in question in the market, which means that there may be cases where the use of public offering is difficult.

Third party allotment is a method in which the shares, etc. in question are allotted only to a specified third party. It is used in cases where the issuing company and such third party form a capital and business alliance, or where the issuing company is unable to use a public offering.

A rights offering (also called as rights issue) is another method of equity financing. When conducting a rights offering, the issuing company allots acquisition rights of the company's shares to all shareholders without consideration, and attains the purpose of fund-raising by having such acquisition rights exercised by shareholders. Shareholders may choose to obtain new shares by exercising such acquisition rights or to receive money by selling acquisition rights in the market.

(c) Issuance of New Shares, etc. at Price Preferable to Subscriber

As stated above, if the amount to be paid-in is "particularly preferable" to a subscriber of the relevant shares," a resolution of a general meeting of shareholders is required for the decision on the issuance of such shares.

Being "particularly preferable" to the extent which requires a resolution of a general meeting of shareholders refers to cases where the amount to be paid-in is lower than the fair price.

Listed companies sometimes refer to the "Guideline on Handling of Capital Increase by Third Party Allotment" published by the Japan Securities Dealers Association. The guideline says, "The amount to be paid-in shall be the price of the day immediately preceding the date of the board resolution for the issuance of new shares (if there is no transaction on the preceding day, the most

recent price preceding such day) multiplied by 0.9 or more. Provided, however, the issuing company may choose the average price during a certain appropriate period of time from a date preceding the resolution for the decision of the price (to a maximum of six months) to the date immediately preceding the date of the resolution multiplied by 0.9 or more, taking the past price before the date of resolution or volume of the past transaction of the company stocks into consideration."

Based on such guideline, if an issuing company issues its new shares at a certain price lower than the price ten (10) percent discounted from the latest price, the company needs to prudently examine whether such issuance falls within the category of an issuance preferable to subscribers.

Upon examining the terms and conditions of issuance, the company needs to conduct discussions based on the market price, paying attention to the credit risk of the issuing company and the possibility of a sellout as well. Independent Directors/Auditors are required to confirm whether the information necessary for decision making by the board of directors is provided, and examine basic materials if necessary, and examine whether the terms and conditions of issuance are decided with the viewpoint of protecting general shareholders' interests in mind.

If a listed company issues new shares of one hundred million yen or more by third party allotment, timely disclosure via a stock exchange is required. The opinion of corporate auditors (including outside auditors) or audit committees on legality relating to whether the amount to be paid-in is not particularly preferable is also required to be disclosed if the relevant stock exchange considers it necessary. Therefore, outside auditors serving as Independent Auditors are required to examine the contents of the calculation report issued by a third party calculation institution (if such report is obtained), and prudently examine the basis for the amount to be paid-in.

(d) Necessity of Fund-raising, Appropriateness of Size of Fund-raising, and Reasonableness of Usage of Funds

For an agendum on fund-raising, examination on the necessity of such fund-raising, the appropriateness of the size thereof and the reasonableness of usage of such funds is important. Especially, since fund-raising by equity causes dilution of rights and interests of existing shareholders via the issuance of new shares, it needs persuasive reasons for such new issuance. The following matters are required to be confirmed based on the reasons for and background of the third party allotment proposal: (i) why the company needs to conduct such fund-raising at this moment; (ii) whether usage of the funds is necessary based on the financial- or business- circumstances of the listed company; (iii) whether the size of the fund-raising is proportionate to the usage of the funds; and (iv) if the third party allotment is accompanied by a business alliance, whether such business alliance is effective for the company. The viewpoint of whether the capital composition after the third party allotment is appropriate for the company's business is fundamental as well.

(e) Decision on Subscriber

Since a subscriber becomes a new shareholder of the listed company, the company needs to prudently examine information on such subscriber unless such subscriber is an existing shareholder or another listed company.

Especially, if the subscriber is an individual or a limited partnership for investment, the background or reasons for selecting such subscriber and their financial resources are required to be confirmed. Timely disclosure requires the information on the subscriber's nature and its financial resources and if such subscriber is neither a listed company nor a trading participant, the listed company needs to submit a confirmation letter, in which the listed company is required to confirm that the subscriber and the relevant parties thereto are not anti-social forces.

In cases where it is found after the resolution on the issuance of new shares that the subscriber has a financial problem and the contribution was not made, the business plan of the company will be adversely affected without the fund-raising as planned, and it may additionally cause a loss of credibility for the company's information disclosure. If the subscriber or its executives, major shareholders or investors (if the subscriber is a fund) are proven to have a relationship with anti-social forces, it may adversely affect the company's reputation or credibility.

Upon confirmation of the subscriber's nature, many companies use an investigation firm to confirm the nature of the subscriber. It may be advisable for Independent Directors/Auditors to ask for the submission of such an investigation report and confirm such details.

(f) Process under Code of Corporate Conduct

Under the Code of Corporate Conduct prescribed in the rules of stock exchanges, if a listed company conducts a third party allotment and the dilution rate caused by such allotment is 25% or more, or such allotment causes change in controlling shareholder, the listed company is, in principle, required to take either of the following measures: (i) receipt of opinion of an entity who has a specific degree of independence from the management regarding the necessity and suitability of such allotment; or (ii) confirmation of the intent of shareholders regarding such allotment via, for example, a resolution in a general shareholders meeting.

In a third party allotment, the management of the company may choose a major shareholder (originally, shareholders should choose the management, but this relationship is reversed in a case of third party allotment). In cases where the influence caused by dilution is significant or a new controlling shareholder emerges, examination by an entity that has a specific degree of independence from the management or determination by existing shareholders is required in addition to the board decision.

Since holding a general meeting of shareholders is time- and cost- consuming for listed companies, many listed companies choose to obtain an opinion as required under (i) above. An "entity who has a specific degree of independence from the management" is supposed to be an independent committee, outside director or outside corporate auditor, and thus outside directors/auditors serving as Independent Directors/Auditors are sometimes requested to express such opinions. In these cases, they are expected to examine the matter from the viewpoint of whether the third party allotment in question contributes to the interests of existing shareholders.

List of references

Katsumasa Suzuki et al., Theory and Practice of Equity Finance, (Shojihomu, 2011)

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9. Fund-raising by Loan

OUTLINE OF AGENDUM

It is proposed that the company borrow one billion yen for operating funds from XXX bank on the following terms:

Term:	Three (3) years from the end of June 2012
Interest rate:	Short-term prime rate plus XX%
Notes:	Other terms and conditions are provided for in the Terms on Banking Transaction stipulated by XXX bank.

ISSUES ON AGENDUM

i) Usage of the funds is not clarified.
ii) Capital composition after such funding is not explained.
iii) Most of the terms and conditions for the financing are quoted from other documents, and the information is incomplete.

VIEWPOINT OF GENERAL SHAREHOLDERS

Fund-raising by loans is to be decided by the management. From the viewpoint of general shareholders, however, the nature of business judgment on loans and that of general business judgment on daily matters, such as the purchase of equipment or hiring of employees, are different. Loans affect the capital composition of the company, and thus are likely to affect the interests of general shareholders. For example, if the ratio of debt to equity increases, it is expected that return on equity (ROE) is enhanced, while the risk of bankruptcy is also increased. We also note that with the recent diversification of financing methods, there are some which are similar in nature to equity.

Independent Directors/Auditors are expected to request the management to conduct discussions in consideration of the viewpoint of general shareholders mentioned above.

CHECKLIST

☑ The board members conduct discussions based on their understanding of the significance of fund-raising by loan.

△: No one expects to review a loan from a bank with which the Company has a long relationship.

△: It is a common assumption among directors that fund-raising is the domain of the executive officer/executive director in charge of finance. Other directors care very little about fund-raising.

○: It is understood among the board members that loans affect the ratio of debt and equity, and thus affect the capital composition of the company. The loan in question is considered a method by which the company can pursue the most appropriate capital composition of the company based on its business model.

◎: In addition to the above, the company considers a loan to be appropriate for the usage of the funds, following a comparative review of various fund raising methods.

COMMENTARIES

(a) Rules for Loans under the Companies Act

Loans from banks are matters to be resolved by a meeting of the board of directors as a "Substantial Loan" under Article 362, Paragraph 4, Item 2 of the Companies Act of Japan. Even if a loan does not fall within such category, there are cases where a company's internal rules such as guidelines on matters to be proposed to the board indicate a loan over certain amount as a matter to be resolved by the board of directors.

(b) Examination of Terms of Loan

As well as other agenda, the first step is to confirm whether the necessary information is provided to the board of directors.

We note in particular that in cases of fund-raising by loan, detailed terms and conditions of the loan agreement are sometimes omitted or quoted from other materials. The forms of loan agreements are diverse, including adhesive terms and conditions for banking transactions, detailed contracts over fifty pages, those accompanied by guarantee agreements or collateral, or structured financing intricately involving ten or more agreements. It may be excusable for the executive officer in charge of such financing to consider it unnecessary to explain all of such terms and conditions.

The board members are not required to understand all the terms and conditions of the loan agreement in question, though it is important for them to be able to confirm such terms and conditions if they consider it necessary.

(c) Usage of Fund

Even if the information on the finance loan in question is fully provided, how carefully the terms and condition of each loan should be examined depends on the particular circumstances of each case. Here, the usage of the funds in question is a matter demanding particularly careful attention.

Usage of the funds in question is an important item that would affect decisions on implementation of such fundraising, and further which fund raising method should be used, depending on the reasonableness of such usage and the details thereof.

If the fund is to be used for a certain business acquisition, comparison of the profit to be generated from such acquired business and that from existing businesses is useful for decisions on the implementation of such loan.

Even if the management reach the conclusion that the company should implement such acquisition, it may be possible for the company to receive a loan with more preferable terms and

conditions with the credit capability of such acquired asset instead of credit capability of the whole company if such acquired business is expected to generate a stable cash flow. In such case, the company should consider structured finance.

In cases where the funds are used for carrying or expanding existing businesses, the company is supposed to make a loan with its own credit.

Even in such cases, if operational funds go in and out in a short period of time, it may be more reasonable for the company to have a commitment line contract rather than making a loan for the aggregate amount in a lump-sum. If a loan is to be used for long-term investment in facilities, the issuance of new shares or corporate bonds may be more reasonable than a bank loan.

Therefore, board members should not be perplexed by words such as "operational funds" or "refinancing," and should make decisions with an understanding of the details of the usage of the funds in question.

Since the board members are sometimes required to examine not only the terms and conditions of the loan in question including the interest rate of the loan, but also the reasons for choosing a bank loan among the various fund raising methods, they are required to have some knowledge of other financing methods.

(d) Selection of Bank

If the company is supposed to receive a loan from a particular bank, the principle of competition is unlikely to work on the terms and conditions of the loan including interest rate. Especially, we should carefully pay attention to cases where a person from the relevant bank assumes the office of directors or corporate auditors. It is a matter of business judgment that the company continues transactions with its main financing bank. However, the board is required to confirm the interest rates of other banks before the final decision, and how the rate of the main financing bank differs from the general standard in the name of respecting their long-term relationship.

(e) Consideration on Capital Composition

We note that a loan is one of the various methods of fund-raising, and has a so-called leverage effect which differentiates it from fund-raising by issuance of new shares.

Generally, an increase in borrowed capital causes an increase in return on equity (ROE) and earnings per share, but it also increases the risk of bankruptcy. An increase in equity capital causes a decrease in earnings per share, but it also decreases the risk of bankruptcy. Additionally, we note that the interest on a loan is treated as deductible expenses for tax purposes, while dividends are not. A company should seek the appropriate capital composition for the company business model and financial situation considering such differences.

List of references

Kazuhiro Takei et al., Handbook on fund raising (Shojihomu 2008)

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10. Disposition of Surplus

OUTLINE OF AGENDUM

It is the company's basic dividend policy to maintain necessary and sufficient internal reserves and make returns to shareholders in a balanced manner. With respect to the year-end dividends for the latest fiscal year, we would like to pay dividends as follows, considering the performance of the latest fiscal year, future business plans and future projections of business, and mid/long-term investment in facilities:

i)Assets to be distributed: Cash

ii)Allocation of distributed assets: X yen per share of common stock, XX yen in aggregate

iii)Effective Date of dividend: MM DD, YYYY

ISSUES ON AGENDUM

i) Basic Policy on Dividends is not concrete, and there are difficulties in determining whether or not it is appropriate.

ii) The use of the internal reserves is not clarified, and thus the appropriateness of the level of dividends is unable to be determined.

VIEWPOINT OF GENERAL SHAREHOLDERS

For general shareholders, disposition of surplus is important as a method of collecting returns on an investment. It would be unwise to conclude that general shareholders demand only returns by dividends or pay back or cancellation of treasury stock, or further by special shareholder benefit plans. If the company may reuse earnings from the company's business effectively, i.e., if the company may reinvest its surplus more effectively than the returns expected by shareholders, new investment without distributing dividends would lead to benefit general shareholders and the company. Thus, the management should establish dividend policies considering the possibilities of effective reinvestment and new investment, and make every effort to explain the reasons the company has adopted such a policy to general shareholders in order to help them understand such reasons.

Independent Directors/Auditors are expected to confirm whether the company's dividend policy is reasonable for general shareholders, and to make an effort to inform investors of the company's thoughts behind its dividend policy.

CHECKLIST

☑ The dividend policy is established from the viewpoint of enhancing corporate value.

△: It is most important for the management to distribute dividends equivalent to past dividends. Even if the company earns significant profits, the management will not consider the return of such profits to shareholders without extraordinary reasons, and usually holds such profits in preparation for dividends to be made the next year or thereafter or in case of unforeseen problems.

○: Certain policies on dividends are established, and the possibility for dividends is discussed, based on the expected demand for cash necessary under the business plans or investment plans for the future.

◎: The company establish its dividend policy based not only on the demand for cash but also return on equity (ROE) and the influence on capital composition. Various possibilities are discussed from the viewpoint of general shareholders, such as the acquisition or cancellation of treasury stocks, dividends, or an increase in the company's stock price via internal reserves and the reinvestment thereof.

COMMENTARIES

(a) Significance of Dividends

Distribution of a surplus is an action by which companies distribute assets to their shareholders. This is one of the essential activities of companies as for-profit entities.

Claim for dividends from surplus is an important right of shareholders as rights to self-interest by which shareholders directly receive economical profits from the company, as well as claims for residual assets.

Returns to shareholders including dividends from surplus is an essential matter for investment decisions of investors, as well as the profitability and growth potential of the company. A questionnaire survey of one hundred fifty two institutional investors conducted by the Life Insurance Association of Japan revealed that almost 90% of investors place top priority on dividends, or select investment destinations with consideration of dividends.

With such background, a dividend policy, i.e., "from after-tax income of a listed company, how much should be paid to shareholders as dividends and how much should be internally reserved and reinvested in businesses" is an important piece of financial management that is to be determined by listed companies.

(b) Determination of Dividend Policy

In what situations should listed companies distribute dividends or hold internal reserves?

Theoretically, if a listed company has an opportunity to raise profits to exceed the cost of capital, it is preferable for the company to make new investments to enhance its corporate value without distributing the surplus available for dividends, which leads to the maximization of interests of general shareholders. This is the basic theory.

Adversely, if a listed company does not have an opportunity to raise profits to exceed the cost of capital, distributing surplus available for dividends leads to the maximization of interests of general shareholders. If the company invests such surplus in a certain investment opportunity from which the company may raise profits to a point below the cost of capital, it would impair its corporate value.

We note that all dividend policies of listed companies are not necessarily determined by the basic theory mentioned above. Whether holding reserves to make new investments or sharing profits with shareholders by offering dividends is more beneficial to interests of general shareholders depends on the taxation system as well, and the idea of holding certain internal reserves for future business risk should be also considered.

The important thing is that listed companies establish dividend policies based on the basic theory above.

Thus, it is advisable for Independent Directors/Auditors to confirm what discussions are made by the management on the basic theory of dividend policies for proposal for appropriation of profit. If the information necessary for such discussion is missing from the materials, it is advisable for them to actively ask questions and to have the board of directors make decisions after reaching a common understanding on such discussion.

(c) Explanation to Shareholders/Investors

When listed companies explain their dividend policy, they should keep the basic theory above in mind.

According to a questionnaire survey of listed companies and institutional investors conducted by Life Insurance Association of Japan, over 90% of listed companies believe that they offered sufficient explanations on their dividend policies including the necessity of internal reserves and investments, while over 70% of institutional investors felt they received insufficient explanations. There is significant gap between listed companies and institutional investors in their view of the matter.

It is advisable for Independent Directors/Auditors to confirm whether explanations on dividend policies are sufficiently made including the necessity of internal reserves and investments, and to request for their review if necessary.

(d) Internal Reserve

From the viewpoint of general shareholders, corporate value is impaired if a listed company holds excessive internal reserves without returns to shareholders in a case where the company has no investment opportunity exceeding the cost of capital and the internal reserve is not effectively used.

How is the level of internal reserves of Japanese listed companies fluctuating? According to a survey conducted by the Life Insurance Association of Japan, the amount of the internal reserves of Japanese companies in the first half of 2011 exceeded the level before the Lehman Shock, to reach record levels.

According to a questionnaire survey conducted by the Life Insurance Association of Japan, 75.9% of institutional investors said the level of internal reserves of Japanese companies was at a "cash-rich level," while 68.8 percent of listed companies said "the level is appropriate." There is a significant gap between listed companies and institutional investors in their view of the matter.

We are not able to conclude only from such situation that internal reserves of listed companies are excessive or that the management of listed companies holds cash reserves beyond necessity for self-protection, because when considering how much internal reserves or cash reserves are necessary, companies need to consider possible changes in outside circumstances and possible

related business risks. It is, however, advisable for Independent Directors/Auditors to reconfirm whether the company's attitude to the appropriate level of internal reserves or cash reserves is sufficiently explained to investors, and request the management make such explanations more appropriately if necessary, and request for a review of the level of the internal reserves or cash reserves if investors' claims are accurate.

(e) Acquisition of Treasury Stock

Although dividends are the most popular method for distributing the company's assets to shareholders, the acquisition of treasury stock by the company also functions in a similar manner in essence.

We note that there are the following differences between dividends from surplus and the acquisition of treasury stock by the company.

First, dividends are distributed to all shareholders without exception, while the acquisition of treasury stocks does not mean the acquisition of shares from all shareholders. Shareholders must choose whether they sell shares and obtain cash at that time or continue holding their shares to enjoy future increases in stock price, while the method of handling cases where the number of shares held by shareholders applying to sell exceeds the number of shares that the company plans to acquire depends on method of acquisition. Some shareholders may not prefer to receive a distribution in cash at that time for tax reasons, and thus being able to choose is possibly a merit of the acquisition of treasury stock. If there is a difference in tax rates for dividends and that for capital gain, one may be preferable to the other.

Acquisition of treasury stock by the company may be an opportunity to send a message that the management believes the current market is not evaluating the company's situation appropriately and the stock price of the company is below the fundamental value of the company. We refer the situation where the stock price is adjusted to the appropriate level by such a message as a "signaling effect." If the management is able to persuasively explain why they believe the stock price is undervalued, the company may conduct an acquisition of treasury stock for such "signaling effect."

The company is expected to determine whether it increases dividends or acquires treasury stock for return to shareholders, while giving consideration to the above mentioned differences.

Independent Directors/Auditors are expected to ask questions to the management regarding the contents of materials so that the board of directors makes decisions on return to shareholders with their understanding of those differences in mind.

List of references

Kenjiro Egashira, The Stock Companies Act, (4th ed. *Yuhikaku*, 2011)

Shosuke Ide & Fumio Takahashi, Introduction to Management and Finance
(Nihon-keizai-shimbun-shuppannsha, 2000)
Matters that Investors want Companies to know (Japan Corporate Governance Forum ed., Shojihomu, 2008) and others.

11. Transactions by Directors with Conflicts of Interest

OUTLINE OF AGENDUM

It is proposed that the company make a home purchase loan to Director A as outlined below. Director A will not participate in the resolution because he has a special interest therein:

Principal:	XX thousand yen
Interest rate:	X % per year
Due Date:	5th anniversary
Security:	First priority mortgage will be created on the acquired real estate.
Notes:	In addition to the above, this transaction is subject to terms and conditions conforming to the rules of home acquisition loans for employees.

ISSUES ON AGENDUM

i) The management seems to lack understanding of the difference between employees and directors.
ii) No materials are provided with respect to the repayment capacity of the borrower, and no materials are provided with respect to other information necessary to judge the appropriateness of the transaction.

VIEWPOINT OF GENERAL SHAREHOLDERS

General shareholders are concerned that the management puts a priority on the interests of other stakeholders and the interests of general shareholders are ignored. Especially when a director who is a member of the board making important decisions for the company has a special interest in an agendum, the fairness of decision making is likely to be impaired by the personal interests of the relevant director. Even if it is not actually impaired, the decision may seem unfair from the viewpoint of general shareholders if a sufficient explanation is not provided.

Because a director having personal interests is likely to be criticized even if he/she fully explains the circumstances, Independent Directors/Auditors who are independent in appearance and in fact are expected to play certain roles.

CHECKLIST

☑ The company observes the process required by laws and regulations, and effective practice for such observation is established.

△: The Company conducted certain actions by which the company may state in the minutes that it observed the processes required under the relevant laws and regulations. The actual decision, however, was made by behind-the-scenes work and a person who has interest in the agendum in question was involved in such behind-the-scenes work.

○: The board members share an awareness of the overall picture and effect of the rules for conflicts of interest, and the responsibilities of directors who vote for the resolution approving transactions with conflicts of interest. The board members make every effort to block influence from parties with interests in the agendum in question.

◎: The previous and subsequent influence from a party with certain interests is blocked off. In addition, actual discussions are made at meetings of the board of directors to carefully consider whether the implementation of such transaction is appropriate as a business judgment.

☑ Explanations are made externally when necessary.

△: Discussions at meetings of the board of directors are never disclosed due to their strict confidentiality, and even the necessity of disclosure is not considered.

○: The Company discusses and considers information disclosure, taking into consideration whether the matter in question draws the attention of the public (whether the necessity of disclosure is high) or whether future discussions at the board of directors suffer as a result of disclosure.

COMMENTARIES

(a) Rules for transactions with conflicts of interest

With respect to a company with a board of directors, directors of the company who plan to make transactions with the company involving conflicts of interest between the company and himself/herself must disclose the material facts of the relevant transaction and obtain approval of the board of directors, and after such transaction he/she must report the material facts of such transaction to the board of directors without delay (Article 356, Paragraph 1, Items 2 and 3, and Article 365 of the Companies Act).

Directors with conflicts of interest are not allowed to participate in the resolution of the relevant agendum as a director with special interests in the resolution (Article 369, Paragraph 2). Whether or not they may attend the relevant meeting is considered in various ways. We note, however, that some people consider that such director is not prohibited from attending the relevant meetings of the board of directors if requested, though he/she has no right to state his/her opinion on the relevant agendum, and he/she must leave the meeting room if requested to do so.

If a company incurs damages as a result of a transaction between the company and a director involving conflicts of interest between them, both such director himself/herself and the directors who voted for the board of directors' resolution approving such transaction are presumed to have neglected their duties (Article 423, Paragraph 3). We note that directors who participate in resolutions of the board of directors meeting and do not have their objections recorded in the minutes are presumed to have voted for such resolutions (Article 369, Paragraph 5 of the Companies Act).

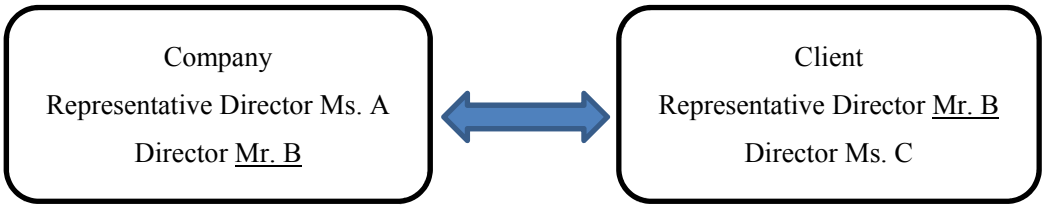
There are no rules for transactions between the company and corporate auditors involving conflicts of interest between them. We note that there are cases with respect to directors where there is an actual conflict of interest between a director and the company even if the situation in question does not fall within the category of transactions with conflicts of interest under the relevant laws (expressing an opinion in the event of a management buy-out is one of such cases.). How to handle this situation is a difficult issue. A director who has an actual conflict of interest with the company may voluntarily decide not to participate in the relevant resolution, and temporarily leave the meeting room during the discussion of the matters relating to such conflict of interest.

(b) Matters of Concern with respect to Transaction with Conflicts of Interest

There are various types of transactions with conflicts of interest between a director and a company. The first thing Independent Directors/Auditors should confirm is the relationship of interests in conflict and the incentives of the relevant directors.

For example, if a director of a company concurrently serves as a representative director of a client of such company, and such representative director of the client represents the client entering

into an agreement with the company, it falls within the category of a transaction with conflicts of interest in that a director of the company enters into an agreement with the company on behalf of a client of the company as a third party to the company, and requires approval of such transaction by the board of directors of the company.



In this case, the interests in conflict are the interests of the company and its client. Because the interests to be protected by the board of directors of the company are the interests of the company, it is important to determine whether a representative of the company (Ms. A) will favor his/her colleague (Mr. B) as a representative director of the company's client, and accept terms and conditions unfavorable to the company.

If there is a director who has a close relationship with the representative director of the company's client, we should pay attention to whether such director included his/her personal feelings in the decision making process or discussions at board meetings.

In cases where the interests of the company and a director directly conflict with each other as shown in the example of "Outline of Agendum," the interests in conflict are comparatively clear. We should note that in the case mentioned in the Outline, both directors who have a close relationship with Director A, and those who have received a loan under the rules for home purchase loans are likely to be biased in making a decision on the agendum.

There are various types of transactions involving conflicts of interest, and in some cases a transaction involves no actual conflict of interest even if it falls within the category of transaction with conflicts of interest in appearance. We need to analyze each transaction depending on its nature, and confirm whether discussions at the board of directors are made impartially and objectively.

(c) Process for Transactions with Conflicts of Interest

Companies are expected to take actions which reflect the purpose of special rules for transactions with conflicts of interest, as well as to implement processes required by the relevant laws and regulations.

Independent Directors/Auditors are less likely than internal directors to feel that they are colleagues of other directors, and are expected to contribute to objective discussion.

For example, if the attendance of a director with a conflict of interest with the company hinders free discussion, it is appropriate to request that such director leave the meeting room.

Because a simple glance of the minutes will reveal who objected to the resolution, there is no reason for such director to remain in the meeting to keep a watchful eye on the discussion.

If the board members feel able to request such director leave the meeting, he/she may hold little influence on the discussion even if he/she remains present. Conversely, if such director has significant influence over the board's discussions, the other board members have difficulty requesting such director leave. In order to avoid unneeded friction, it may be a good idea for a company to establish the practice of always having directors with special interests leave the meeting room.

It should be reconfirmed among the board members that a director who voted for the resolution approving a transaction with conflicts of interest is assumed to have neglected his/her duties when the company incurs certain damages from such transaction, in order to avoid situations where directors carelessly approve transactions with conflicts of interest. There are many trivial transactions involving conflicts of interest, and such reconfirmation may be unnecessary in certain cases. With respect to significant transactions with conflicts of interest, however, it is useful for the board members to make such reconfirmation every time.

(d) Business Judgment and Transactions with Conflicts of Interest

Even if the required process for transactions with conflicts of interest is observed and as a result impartiality and objectivity of discussions for such transaction are secured, it does not mean that the management is always required to approve such transaction. Even if such transaction has no issue as a transaction with conflicts of interest, it should be separately considered whether such transaction is appropriate from the perspective of business judgment.

With respect to the example in the Outline, if the company makes a loan of 5 years to a director with a 1-year term of office remaining, removal or non-reappointment of such director would lead to a decrease in the collectability of such loan. It creates incentives to reappoint such director regardless of performance.

If the funds are raised by the company through a bank loan or the market, it is ideal for the company to use such funds for its businesses. Even if the collectability of the loan is high and the interest rate thereof is appropriate, we should examine whether such usage conforms to the usage that general shareholders expect, with the exception of cases where the company conducts a home acquisition loan business.

List of references

Kenjiro Egashira, The Stock Companies Act, (4th ed. *Yuhikaku*, 2011)
and others

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12. Transaction with Controlling Shareholder(s)

OUTLINE OF AGENDUM

It is proposed that the company acquire the following fixed asset:

Name of Building:	XXXX
Location:	XX, Tokyo
Structure:	Steel-framed reinforced concrete structure, fifteen (15) stories above ground and three (3) stories below
Land Area:	XX square meters
Total Floor Area:	XX square meters
Price:	XX yen
Seller:	XX Company (our Parent Company)

ISSUES ON AGENDUM

i) We need to confirm the results of comparative discussions on other assets or other sellers, and the background for the above mentioned proposal.

ii) We are not able to confirm from the relevant materials whether the terms and conditions of this transaction are not unfavorable to minority shareholders of the company.

VIEWPOINT OF GENERAL SHAREHOLDERS

Controlling shareholders or other major shareholders of a company ("Controlling Shareholders, etc.") may affect the management of the company by exercising their voting rights. With respect to their bargaining power, it is not impossible for them to have the company accept unfavorable terms and conditions in a transaction with the company. If unfavorable terms are imposed on the company, Controlling Shareholders, etc. benefit from such transaction at the expense of other minority shareholders (including general shareholders).

Even under the current laws and regulations, prohibition of pay-off or duties of care of directors exist as a legal seawall to protect the company from such Controlling Shareholders' actions. However, from the viewpoint of general shareholders who are not familiar with the company's insider details, they may become concerned that controlling shareholders will exploit them without their knowledge when they face a case of exploitation case as occasionally reported.

Having Independent Directors/Auditors examine discussions at the board of directors from the viewpoint of general shareholders is one method to ease such concerns.

CHECKLIST

☑ The issues to be raised by a transaction with controlling shareholders are recognized among the board members and the management takes action while giving their full attention to such issues.

△: Board members are under the mistaken impression that response to requests from controlling shareholders, including the parent company, displays the competence of the subsidiary's management, with no consideration paid to the interests of the subsidiary's minority shareholders.

○: In addition to the rules under the relevant laws and regulations, it is commonly recognized among the management that a "Policy on Protecting Minority Shareholders" will be publicly announced when the company has controlling shareholders or quasi-controlling shareholders.

◎: In addition to the above, not only the terms and conditions of transactions with controlling shareholders, but also whether implementation of such transaction truly benefits the company are carefully examined. In cases where a director from a parent company is present, any unfair exercises of influence from such director is blocked.

COMMENTARIES

(a) What means by Controlling Shareholder?

A controlling shareholder includes:

i) A parent company of the company; or

ii) An individual who has power controlling the company equivalent to a parent company of the company (an owner of the company).

The existence of controlling shareholders and their names are items to be reported in the "Report on Corporate Governance," and we can confirm such information in the report. The Report on Corporate Governance of a listed company is publicly available on the website of the stock exchange on which the company in question is listed.

The fact that a controlling shareholder exists in a listed company is not a problem. We note however that there is a possible conflict of interest between a controlling shareholder and minority shareholders (general shareholders) of a company, and thus it is possible that the interests of minority shareholders in such company are impaired. Controlling shareholders hold many voting rights, and matters to be resolved at general meetings of shareholders, such as the election of directors, are at their discretion. With such controlling power, a controlling shareholder of a company may affect the management of the listed company.

In many cases, the interests of the controlling shareholders and those of minority shareholders are not in conflict. Enhancement of the corporate value of the company benefits both minority shareholders and the controlling shareholders. However there are cases where the interests of the controlling shareholders and those of minority shareholders are in conflict.

For example, in cases where the parent company of a company and the company enter into a construction agreement, as contractor and subcontractor respectively, the parent company has incentive to lower the consideration for such subcontract in order to minimize its costs, while minority shareholders of the subsidiary prefer to maximize such consideration. This is a conflict of interest. If the directors of the subsidiary consist only of persons who reflect the intentions of the parent company, it is unlikely that a fair consideration for such contract acceptable to minority shareholders of the subsidiary will be agreed upon. An important role of Independent Directors/Auditors is to protect the interests of minority shareholders in such cases and to pay attention so that the interests of minority shareholders are not impaired.

Since we are concerned that a parent company with its controlling power will force its listed subsidiary to make transactions under terms and conditions unfavorable to the listed subsidiary (which means favorable to the parent company), TSE has stipulated rules of disclosure in relation to this. A company with a controlling shareholder must disclose the company's "policy for protecting minority shareholders in transactions with controlling shareholders" in its Report on Corporate

Governance, and is further required to disclose the implementation situation of such policy annually in the "Matters with respect to Controlling Shareholder" report, as well as the name(s) of controlling shareholders and quasi-controlling shareholders, the ratio of voting rights, and matters relating to transactions with controlling shareholders.

With respect to the actual description of such policies, there are cases where a company stated that (i) from the viewpoint of terms and conditions of transactions, the company plans to make fair transactions with controlling shareholders after consultation with the terms and conditions of similar transactions with third parties and (ii) from the viewpoint of the process for transactions with controlling shareholders, the company plans to decide the implementation of transactions with controlling shareholders after consultation with outside directors not from its parent company and conduct discussions based on such consultation. If your company is a listed company with controlling shareholders, you should confirm the contents of the company's policy.

(b) Process for Significant Transactions with Controlling Shareholders under Listing Rules

When a listed company makes significant transactions with its controlling shareholder, the listed company is required under the listing rules of TSE to obtain an opinion from someone who has no interest in such controlling shareholders on whether the decision on such transaction is not unfavorable to minority shareholders.

Such rules are intended to avoid decisions unfavorable to minority shareholders in the event where the interests of a controlling shareholder and minority shareholders actually are in conflict.

SIGNIFICANT TRANSACTIONS

Requiring listed companies to obtain such opinion for all transactions with controlling shareholders will be too cumbersome for the listed companies. So this process is applicable only to a significant transaction that requires timely disclosure and is not applicable to daily transactions.

The definition of "Significant Transactions" is stipulated by the TSE listing rules in detail. Here, we omit the explanation of such details, but put simply, they are "transactions so significant that timely disclosure is required." For more details, please refer to the "Guidebook on Timely Disclosure of Listed Companies" published by TSE and distributed to TSE-listed companies.

PERSONS WITH NO INTERESTS IN CONTROLLING SHAREHOLDER

A person who has no interest in controlling shareholders is supposed to be, for example, a commissioner of an independent committee, or outside director/auditor who has no interests in controlling shareholders.

Thus, Independent Directors/Auditors are in a position to express opinions on whether the transaction in question is not unfavorable to minority shareholders. It does not mean, however that Independent Directors/Auditors themselves must calculate the price of assets to be acquired in the example in Outline of Agendum. It is possible for Independent Directors/Auditors to confirm whether they are sufficiently provided with materials necessary to express their opinions, and to ask for additional materials if they are not sufficiently provided.

If the company establishes an independent committee and requests for their opinion on such transaction, Independent Directors/Auditors need to examine the independence of such committee.

(c) Criteria for Matters to be Resolved by the Board of Directors

Under the Companies Act, the board of directors has the authority to decide “disposal of and acceptance of assignment of important assets” (Article 362, Paragraph 4, Item 1 of the Companies Act). Since what is “important” varies depending on the size and nature of the businesses of each company, it is not uniformly stipulated under the relevant laws. Therefore, many listed companies establish their “Criteria for Matters to be Resolved by the Board of Directors,” and it is stipulated that the disposition of assets equal to or more than a certain amount is necessary to be resolved by the board of directors.

According to a questionnaire survey conducted by the editorial department of *Shojihomu,* with respect to items of “borrowing in a significant amount,” “election and dismissal of an important employee including managers,” and “establishment, changes or abolition of important structures including branch offices,” many companies have criteria for a “significant amount” or “important,” as well as “disposal of and acceptance of assignment of important assets.”

In addition to the above, matters that are likely to significantly affect the company such as the “annual business plan,” “annual budget,” “entry into new business,” “changes in business policies,” “changes or abolition of businesses,” “creation of business strategy,” and “business alliances” are stipulated as matters to be resolved by the board of directors.

From the viewpoint of Independent Directors/Auditors, "Criteria for Matters to be Resolved by the Board of Directors" are important criteria that decide what matters are to be reviewed by Independent Directors/Auditors, in addition to the matters required to be resolved by the board of directors under the Companies Act. Independent Directors/Auditors should confirm what criteria their own company has established.

From the viewpoint of protecting general shareholders, some people may believe that it is important that Independent Directors/Auditors examine as many cases as possible. However, it is unreasonable to have daily matters not significant for the company to be resolved by the board of directors. There is no correct answer applicable to all companies. Balanced handling is important.

Therefore, the board members are expected to occasionally examine whether the criteria suit the size and nature of the company's businesses.

List of references

Koji Toshima, *Current Situation of Laws governing Listed Companies learned from Factual Analysis – Investment in Listed Companies and Capital Policy*, 364 Bessatsu Shojihomu, Ch.3 (2011)

Actual Operation of Board of Directors under Companies Act, 334 Bessatu Shojihomu (Editorial Department of Shojihomu ed., Shojihomu 2009)

Mikio Sonoda, *Practical Point of Code of Corporate Conduct with respect to Significant Transactions with Controlling Shareholders*, 1938 Junkan Shojihomu, 34 (2011)

13. Management Buy-out and Other Actions to Become Closed Company

OUTLINE OF AGENDUM

With respect to a tender offer triggered by the Tender Offer Notification dated MM DD, YYYY (outlined below), it is proposed that the company express its favorable opinion for it.

Tender Offeror:	XX *Kabushiki Kaisha* (The special purpose company contributed by XX limited partnership for investment and Mr. XX, the representative director of the company)
Offered Price:	XX yen (Current Price plus Premium of 25%)
Term of Tender Offer:	From MM DD 201X to MM DD 201X
Cash Out:	To be conducted at the same price as the tender offer price.

ISSUES ON AGENDUM

(i) Basis for the tender offer price is not explained.

(ii) Directors with actual conflicts of interest and the degree of their involvement in the acquisition are not clarified.

VIEWPOINT OF GENERAL SHAREHOLDERS

For general shareholders, MBO is an opportunity to sell out its shares at a premium price, while they are forced to lose one of their investment destinations and change their portfolio because of such MBO. The management members who participate in the MBO as the acquirers and general shareholders are in conflict of interest and thus general shareholders may feel exploited, which sometimes leads to disputes.

Independent Directors/Auditors are expected to confirm whether discussions are made with the significance of the MBO in mind, whether any measures to block off the influence from stakeholders are taken and whether shareholders are fully informed.

CHECKLIST

☑ The relevant discussions are made with the MBO's structure and its significance in mind.

△: Only the management policy and treatment of each director/auditor after the MBO draw attention, and discussion on MBO itself is poor.

○: After prudent discussions on pros and cons of the MBO, the company sincerely conducts negotiations on the price to protect the interests of existing shareholders including general shareholders and expresses its opinions on the tender offer based on the results thereof.

◎: Full information and appropriate explanations are provided to existing shareholders including general shareholders.

☑ The conflicts of interest are recognized and appropriate measures are taken.

△ : The board of directors do not understand whose interests they should represent, especially in cases where the management members who participate in the acquisition hold a certain number of shares of the company's stock.

○: Conflicts of interest are explicitly recognized, and certain measures to ensure sincere negotiations are appropriately taken according to the actual situation.

◎: Influence from stakeholders are actually blocked off and such situation is assured in appearance as well, by which even general shareholders who have little opportunity to be informed of internal circumstances may entrust their interests to the board decision.

COMMENTARIES

(a) What is an MBO?

MBO means the acquisition of a target company in which the target company's management participates as an acquirer. Typically, it is accompanied by a tender offer and cash-out of minority shareholders thereafter.

If stocks or stock acquisition rights issued by a stock company (*kabushiki kaisha*) become the target of a tender offer, the company is required to express its opinion of approval or rejection of the tender offer, and timely disclosure of such opinion is also required under the listing rule.

Upon deciding the offered price, a director/corporate auditor who participates in the acquisition as an acquirer is deemed to have a so-called conflict of interest. He/she, as a director/corporate auditor of the target company, is required to take actions to raise the price as much as possible for shareholders of the target company, while, as an acquirer, reducing the price is beneficial to himself/herself. Because of the management's conflict of interest, there is no guarantee that a fair MBO price can be determined without appropriate measures. This is the point where MBO is different from other corporate acquisition transactions.

In this section, we assume cases where Independent Directors/Auditors do not participate in the acquisition.

(b) Fair Price

In determining the purchase price, directors/corporate auditors who do not participate in the acquisition are expected to protect the fair interests of general shareholders from the standpoint of conflicting with the management who participate in the acquisition.

Because many employees are engaged in their duties under the direction of the current management, and are expected to work for the current management even after the acquisition, and further the number of employees who are engaged in affairs related to the acquisition is usually limited because of information control, it is not easy for directors/auditors who do not participate in the acquisition, including Independent Directors/Auditors and limited number of employees, to fully protect the fair interests of general shareholders by themselves.

An appropriate MBO price is required to reflect the increase in corporate value that is likely to be attained after the MBO, and is sometimes brought to court, which means a fair MBO price is significant to the acquirer as well from the viewpoint of avoiding any disputes.

Directors/corporate auditors who do not participate in the acquisition may consider establishing an independent committee on behalf of general shareholders consisting of professionals and intellectuals in order to have them calculate the price or negotiate with the acquirer for the target company. There are a variety of ways or approach to protect existing shareholders, and thus

companies are required to handle situations in a way appropriate for the actual case while referencing precedents.

(c) Special Committee

If the company establishes an independent committee that has no interest in the management and has them negotiate the purchase price, Independent Directors/Auditors are required to examine whether the independence of such independent committee is secured, how the process of decision making of the independent committee is conducted, and whether such decision making is appropriate.

Since the independent committee should not have any conflict of interests with general shareholders, it is important that the appointment of its members is conducted fairly. If a member of the independent committee has a family relationship or significant transaction relationship with the management, his/her appointment as an independent committee member should be avoided because he/she may will have no credibility with general shareholders because of his/her appearance even if he/she is in fact not affected by the management involved in the acquisition.

If discussions by the independent committee reflect the intentions of the management, conclusions reached by the independent are unlikely to be fair even if members of the independent committee are independent of the management, and the process for discussions should be fair from viewpoints other than independence from the management.

Independent Directors/Auditors are expected to examine appropriateness of the independent committee from the viewpoint of how the independent committee examines the matter or what kind of materials the independent committee collects.

(d) Reasons for MBO

From the viewpoint of maximization of corporate value, the reasons for MBO should be fully discussed. For example, if the reason for MBO is "to have the company unlisted for bold management reform," we need to examine whether such management reform cannot be implemented without becoming unlisted. If the reason for MBO is "a cutback of listing expenses," we need to examine whether there is a plan for re-listing and the target period thereof, and whether the cost of the MBO added to cost of re-listing exceeds the cost necessary for being listed during the target period.

With respect to the cost for the MBO, many MBO are expected to be covered by debt loans to be secured by the target company's assets (leveraged buyout or LBO). This would dramatically change the capital structure of the company. Since the company has no general shareholders after the completion of the MBO, this is an issue beyond the expected role of Independent Directors/Auditors. However, Independent Directors/Auditors are required to pay

attention to the direction of businesses after the completion of the MBO. We note, in addition, it is indicated that MBOs implemented in an arbitrary way may be viewed as cheating investors.

(e) Process of Board of Directors and Conflicts of Interest

The Companies Act provides rules for cases where a director makes a transaction with a conflict of interest with the company. However, since expression of the company's opinion is not a transaction, such rule is not directly applicable thereto. It is, however, apparent that we are not able to expect the management as an acquirer in the MBO in question to make impartial judgment. Thus it is advisable that they do not participate in the resolution of the MBO due to having special interests in the MBO in question.

Since fairness of board resolutions is important for all stakeholders, Independent Directors/Auditors are able to ask for appropriate handling depending on the circumstances surrounding each MBO.

List of references

Masaki Shizuka, *Issues on MBO compared with IPO - debut in and retirement from the securities market*, 201 MARR, 19 (2011).

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14. Approach to Corporate Scandals

OUTLINE OF AGENDUM

Having received a press report that an unpermitted substance is detected in the company's products, the company establishes an investigation team consisting of two outside auditors of the company, two outside lawyers and one internal director in charge of compliance with the support staff from the internal control division in order to have them conduct the following investigation:

Purpose of Investigation: To reveal the facts
Deadline for Investigation : By the next board meeting

ISSUES ON AGENDUM

(i) Whether or not any public announcement was made on establishment of the investigation team and the result of such investigation is not clarified.

(ii) Although the purpose of the investigation was to reveal the facts involving highly professional/technical issues, no professionals for the relevant area are included in the members of the investigation team nor the support staff. The composition of the team does not conform to the purpose of the investigation.

(iii) Although the influence on general consumers is significant, the deadline for the investigation seems determined for operational convenience.

VIEWPOINT OF GENERAL SHAREHOLDERS

Handling of a scandal of a company will greatly affect the survival of the company. Internal directors/auditors are likely to hesitate in responding to such cases because it is sometimes accompanied by pursuit for responsibilities of their colleagues, and if they handle it they are suspected of treating such scandal tolerantly regardless of whether they actually did so. Meanwhile, since a mere third party is likely to lack information, special knowledge, or experience on the company's businesses, we are not able to simply leave such scandals to third party investigation.

Independent Directors/Auditors, being in between internal directors and outsiders, are expected to play an important role in the establishment of an appropriate framework depending on the size or nature of scandal.

CHECKLIST

☑ Discussions are conducted with the method of solution and settlement in mind, based on the size or nature of the scandal, how the scandal is exposed, and response from the public.

- △: No direct discussion is conducted on the scandals at the board of directors and the scandal is treated like taboo topic. The board made a decision that resolution of the scandal was left to the directors in charge of it.
- ○: Direct discussion of the scandal is made at the board of directors for settlement thereof, although too much criticism against the persons responsible for the scandal or opinions trivializing the scandal are included therein.
- ◎: Remedial measures for the scandals, including timing of the announcement or the contents thereof, are discussed in order to implement duties owed against shareholders and settle the scandal as soon possible.

☑ Someone who is likely to be responsible for the scandal does not unfairly affect the discussion.

- △: The person who is responsible for the scandal is continuously in charge of handling of the scandal only because he is knowledgeable about the relevant matters. No one is concerned with conflicts of interest. The responsible official at the time of the exposure of the scandal (ex-responsible official) unfairly affects the discussion.
- ○: The management takes measures to exclude unfair influence from a person who has special interests in the scandal. Topics, such as whether each individual responsible for the scandal should resign or who is responsible for the scandal, are discussed only if they are necessary for handling of such scandal.

COMMENTARIES

(a) Rules for Handling Scandals

While it is ideal for the company to prevent scandals from occurring, it is not realistic for the company to take all measures in advance on every assumption. In addition, if the company takes preventive measures randomly, it will disturb the effectiveness of the company's businesses. The larger the company, the more supervision or auditing needs to be conducted by indirect or risk-based approaches. To state it bluntly, the occurrence of scandals cannot be avoided.

History tells us that the company's reputation or social credibility may be impaired by the mishandling of the scandals, and in some cases it may cause a situation that affects the company's survival. Therefore, the handling of scandals, in many cases, falls within the category of "execution of important operations" that requires a board resolution (Article 362, Paragraph 4 of the Companies Act).

Listed companies are required to disclose information that is significant to investment decisions under the rules of stock exchanges. While the items to be disclosed range across various areas, with respect to scandals, cases where the damages caused by the scandal in question are likely to be equivalent to three (3) percent of the net assets of the company or cases where the company is accused of certain legal infringement by the relevant ministry fall within the categories of disclosed items.

We further note that the establishment of a framework for detecting scandals is also important. Especially in cases where the management is engaged in a scandal, a whistle-blowing system designed to be ultimately reported to the management has questionable effectiveness. It may be an option for companies to design such system so that such whistle-blowing is reported only to Independent Directors/Auditors if the management is likely to be engaged in the scandal in question.

We hereby provide some explanations on how the board of directors should handle situations where a scandal is actually revealed or a possible scandal is detected.

(b) Purposes of Scandal Handling

The purpose of the scandal handling is, in many cases, to resolve confusion and restore normal operations although there are a variety of possible purposes.

To achieve such purpose, independent committees or internal investment committees have been often established in recent large-scale scandals in order to investigate the relevant facts or the persons responsible for the scandal and to formulate preventive measures.

We note, however, that corporate scandals vary, and there is no single correct answer for handling therefor.

This is a difficult problem, but appropriate handling is required to be taken depending on the size and nature of the scandal, possibility of exposure of further scandals or expansion of existing scandal, how the scandal is exposed, and the response from the public.

(c) Significance of Independent Committee and Internal Investigation Committee

The board of directors has the authority to make decisions on almost all matters of business operations, and that is applicable to the handling of scandals.

However, since handling of scandals is accompanied by certain punishment of those involved, the board decision may be considered lenient or expedient. Particularly, if such criticism spreads in a case drawing public attention, both the scandal itself and the board decision draw public condemnation and the situation becomes worse.

For instance, if a director or corporate auditor is engaged in a scandal, and their responsibility is likely to be pursued through shareholder derivative action or other actions, punishment made by the board may be considered evasion of accountability or lenient from the viewpoint of the public that is not familiar with internal circumstances even if it is actually proportionate.

Thus, balance between the process and conclusion is necessary. If the process for a scandal is fulfilling, the public may be satisfied even with a lenient conclusion, while an over-strict conclusion is necessary for a scandal with a poor resolution process.

Establishing an independent committee contributes to fulfilling the resolution process for scandals. By entrusting certain authority to such independent committee, the company may remove a factor of possible criticism such as concerns as colleagues or avoidance of accountability so that they may take only necessary and sufficient measures in response to the scandal.

We note however that the belief that independent committees solve everything for scandals is excessive.

Independent committees need some time to understand the background of the scandal in question because of their lack of knowledge regarding special internal circumstances, business customs, or technical matters, and in the worst cases it may be possible that they reach a conclusion based on a misunderstanding.

We further note that clearly having no interests in the company makes them able to make independent and unbiased judgments, while on the other hand they have little commitment to the company's future.

In order to counterbalance such demerits, some companies include internal persons or professionals in the independent committee. Some people refer to such committees consisting of both independent individuals and internal personnel as "internal investigation committees" in order to differentiate them from independent committees. Such internal investment committees are

expected to make up for the demerits of independent committees, despite involving the same demerits as cases of scandals handled by internal personnel as mentioned above.

In the event that this would affect the company's survival, the company needs to prudently consider who the best entity is to entrust with such important roles, referencing past examples, so that the merits may be maximized and demerits minimized.

(d) Establishment of Appropriate Investigation System

The most appropriate investigation system may vary depending on the scandal. If the scandal involves professional or technical issues, the requirement for knowledge of internal personnel increases. If the scale of scandal is large, the company is likely to be delisted, or the scandal is exposed by the press, the requirement for due process increase since the scandal will draw attention from the public and is likely to lead to liability issues for executives.

Individuals with no relationship to the company lack knowledge or understanding of business customs or technical matters, while impartial judgment can be expected from them. Internal personnel who are in charge are familiar with various backgrounds, while they may be forced to make difficult decisions that may lead to the resignation of their colleagues or subordinates and the credibility of investigation may decrease because of their involvement. Independent Directors/Auditors are in between both of these options and have both the merits and demerits thereof.

If the purpose of the investigation is to reveal facts or to determine responsibility, the knowledge of legal professionals would be helpful, and for the establishment of frameworks for preventive measures, certain professionals with knowledge of internal controls would be helpful.

In addition to the selection of investigation members and the purpose of the investigation, the points of entrustment by the board and the company attitude toward public announcements are also important. The Japan Federation of Bar Associations published the "Guideline on Independent Committees for Corporate Scandal," which includes effective suggestions not only for independent committees but also for internal investment committees. We recommend reading through it.

List of references

Daiichi Tokyo Bar Association General Law Research Institute Companies Act Task Force, Handling of Corporate Scandals (Case Study) (Seibunsha 2009)

The Japan Federation of Bar Association Lawyers' Business Improvement Committee, Commentaries on "Guideline on Independent Committees for Corporate Scandal" (Shojihomu, 2011)

Referential materials

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Referential materials

1. Expected Role of Independent Directors/Auditors

Expected Role of Independent Directors/Auditors

March 31, 2010
Tokyo Stock Exchange, Inc.
Advisory Group on Listing System Improvement

In December 2009, Tokyo Stock Exchange, Inc. (hereafter "TSE") partially revised the Securities Listing Regulations and related rules. As part of the corporate governance framework desired of all listed companies, listed companies are required to secure at least one independent director/auditor pursuant to Rule 436-2, Paragraph 1 of the Securities Listing Regulations.

From the viewpoint of facilitating understanding of and promoting the establishment of the independent director/auditor system, the Advisory Group on Listing System Improvement has compiled in the following pages a summary of the significance and role expected of independent directors/auditors.

The key point in the application of this system is in bearing in mind its main purpose of protecting general shareholders. If the system falls into formality, and is applied against its intended purpose (for example, a person notified to the TSE as an independent director/auditor acts against the expectations of general shareholders), not only will shareholders/investors lose trust in listed companies, but also the domestic securities market as a whole will lose both domestic and foreign credibility. Thus there is a concern that such a situation will become a factor in reducing the global competitiveness of the Japanese economy.

Therefore, it is appropriate for the TSE to persist in requesting a suitable response from individual listed companies in consideration of the idea behind the implementation of the independent director/auditor system. This is based on the premise that the TSE needs to strive to facilitate and disseminate a proper understanding of the idea behind the system, and the role expected of independent director(s)/auditor(s), amongst independent director(s)/auditor(s) of listed companies and all parties related to listed companies.

The Significance of Independent Directors/Auditors

The TSE "Principles of Corporate Governance for Listed Companies" advocate the appropriate operation of corporate governance for listed companies is a vitally fundamental requirement for enhancing corporate value on a continuous basis.

In general, companies have various stakeholders such as shareholders, management, employees, clients and creditors. What listed companies have both in common with, and are at the same time unique from other companies, is the existence of general shareholders.

Listed companies have a large number of shareholders who change with trading of the listed company's stock in the secondary market. The shareholder ratio of each of these respective shareholders is extremely small, and as such, they do not have a significant influence on company management. Such shareholders are known as general (or minority) shareholders. Listed companies benefit from the existence of general shareholders in various ways, such as gaining access to smooth fund-raising opportunities. However, due to general shareholders' lack of influence on company management and the high liquidity of the listed company's stocks in the market, the company management may well tend to neglect such general shareholder interests.

For listed companies, general shareholders are an indispensable presence. Their interests may be rephrased as shareholders' common interests and this usually coincides with the interests of the listed company. As such, in terms of achieving business objectives and aiming for sustained improvement in corporate value, it is extremely important for the company management to carry out business operations in consideration of general shareholder interests.

In addition, the proper protection of general shareholder interests is a condition required to fully harness the benefits of the fund-raising function in the securities market, and can also be said to form the basis for the listing system for stocks. It follows that an environment which properly

protects general shareholder interests is also crucial for the development of not only listed companies but also the nation's economy.

Most of the stakeholders surrounding listed companies stand to gain from the company's enhanced corporate value. However, stakeholders do not always share a common interest. Therefore adjustments managing such varying interests are carried out through the course of daily management. Yet, in some cases, it may be inappropriate to entrust such adjustments of conflicts to daily routine management.

In particular, in a situation of highly conspicuous conflicts of interest between the management of a listed company and general shareholders, there is a possibility that a decision which undermines general shareholder interests will be made. In such a situation, there is a great need for a framework, which makes fair and justifiable decisions which take into account general shareholder interests, to be established within listed companies.

With regards to this point, for example, in relation to MBO (Management Buy-out), it is recommended in the "Guidelines on Increasing Corporate Value and Ensuring Regulatory Compliance in the Context of Management Buyouts (MBOs)." (published by the Ministry of Economy, Trade and Industry on September 4, 2007) that in an effort to exclude arbitrariness from the decision-making process, a person from an independent position should be consulted on the justification for and conditions of the MBO, and the resulting decision based on such consultations should be honored.

In addition, in relation to takeover defense measures, it is stated in the "Guidelines Regarding Takeover Defense for the Purposes of Protection and Enhancement of Corporate Value and Shareholders' Common Interests" (published by the Ministry of Economy, Trade and Industry, and the Ministry of Justice on May 27, 2005) that if a corporate structure is designed to honor the

judgment of a highly independent outside director(s)/auditor(s), who strictly supervise activities aimed at protecting internal board members, it will have the effect of shareholders and investors trusting the impartiality of the decision made by the board.

Furthermore, in relation to placements of new shares to a third party, in the TSE listing rules, out of third party allotments, in the event of share dilution of 25% or more, or when a change in the controlling shareholder is expected, listed companies are required to either obtain from a person, who has a specific degree of independence from the company management, an opinion regarding the necessity and suitability of such allotment, or confirm the intent of shareholders regarding such allotment by means such as a resolution in the general shareholders meeting.

The point in common in these guidelines and rules is the idea that in the event that of a clear conflict of interest amongst the stakeholders of a listed company, incorporating the objective judgment of a person from an independent position in the decision making process is an effective and necessary approach for fair and justifiable decisions which take into account general shareholder interests.

This issue is not limited to situations where the conflict of interest between the company management and general shareholders becomes highly conspicuous as mentioned above. When we consider that decisions made in the course of daily management may ultimately undermine general shareholder interests, involving a person from an independent position in the decision making process under normal circumstances will, again, be effective and necessary for fair and justifiable decisions which take into account general shareholder interests.

In such circumstances, the decision making process for significant matters at a listed company is conducted by convening directors and auditors to a board meeting. As such, it is

important to secure director/auditor who participates in the board meeting as a person(s) from an independent position.

With regards to the corporate governance of listed companies, in the end, a framework most suitable and effective for the company should be established through continuous discussion and agreement between individual companies and their shareholders. At the same time, since listed companies' stocks are available for investment by a large unspecified number of investors in the securities market, in consideration of general shareholder interests, there should be a corporate governance framework that is expected in all listed companies. This framework also needs to be objective and easy to understand.

The significance of the independent director/auditor system is as described above.

Expected Role of Independent Directors/Auditors

Independent directors/auditors are expected to take action in light of protecting general shareholder interests, such as raising opinions, etc. so that general shareholder interests are considered in such situations as business execution decisions made by the board of directors, etc. of listed companies.

General shareholder interests are basically taken care of through enhancing the corporate value of a listed company, and the role for such enhancement should be essentially borne by all directors and auditors of the listed company. The reason for requiring listed companies to appoint an independent director/auditor is that, due to general shareholders' lack of influence on company management and the high liquidity of the listed company's stocks in the market, the company management tends to neglect such general shareholder interests. Given that listed companies are required to secure at least one independent director/auditor and that an outside director or auditor is also eligible for the position, independent directors/auditors are expected to act to protect general shareholder interests. Such actions include encouraging board decisions which consider these interests through taking opportunities to express their opinions and raise issues, etc. from the viewpoint of general shareholder interests in the decision-making process, and sharing such opinions and issues with other directors/auditors on the board.

(Points to take note)

· It is desirable for independent directors/auditors to fulfill the role mentioned above by, for example, making appropriate decisions in consideration of the following points.

- Is the business execution decision, etc. at a listed company reasonable from the perspective of achieving business objectives of the company and enhancing its corporate value?

  In particular, is there sufficient consideration for general shareholder interests?
- Is there enough information necessary for the independent director/auditor to properly evaluate business execution decisions, etc. provided in advance?
- Is there any structure/arrangement designed to accurately and appropriately disclose, the objective, content of the business execution decision, etc. and its effect on corporate value?

· It is desirable that an independent director/auditor appropriately exercises the rights of outside directors or outside auditors prescribed in the Companies Act, to protect general shareholder interests.

＊ The protection of general shareholder interests does not exclude, in a situation which requires adjustments to manage conflicting interests of other stakeholders, the consideration of the interests of such other stakeholders.

＊ Measures that independent directors/auditors should take to protect general shareholder interests are not limited to preventing corporate misconduct and reining in activities that entail excessive risk. These measures may include, verbal statements encouraging proper action to realize the enhancement of corporate value, in situations where a decision related to

business execution is to be made. (In cases where an independent director/auditor is a statutory auditor, such independent directors/auditors may possess different rights from those of a director in relation with rights under the Companies Act.)

· It is desirable for an independent director/auditor to always remain highly sensitive to the voice and expectations of general shareholders.

* This does not mean receiving feedback directly from each individual shareholder.

· It is desirable for an independent director/auditor to always make considerations to maintain smooth communications with other directors, auditors, business executives and employees at the listed company.

* In order for an independent director/auditor to properly fulfill the role with regard to protecting general shareholder interests as mentioned above, it is necessary for all other directors, auditors, business executives, and employees at the listed companies to understand the role expected of independent directors/auditors, and make efforts to facilitate the proper functioning of the independent director/auditor system (such as developing a system to disseminate information in a timely and appropriate manner to independent directors/auditors, collaborating with departments, and securing support staff members).

2. Related Rules and Regulations

Securities Listing Regulations (as of May 10, 2012)

Rule 436-2. Securing Independent Director(s)/Auditor(s)

1. For the protection of general investors, an issuer of listed domestic stocks must secure at least one independent director/auditor (meaning an outside director (meaning an entity falling under an outside director prescribed in Article 2, Item 15 of the Companies Act who is an outside director/auditor prescribed in Article 2, Paragraph 3, Item 5 of the Ordinance for Enforcement of the Companies Act (the Ordinance of the Ministry of Justice No. 12 of 2006)) or outside auditor (meaning an entity falling under an outside auditor prescribed in Article 2, Item 16 of the Companies Act who is an outside director/auditor prescribed in Article 2, Paragraph 3, Item 5 of the Ordinance for Enforcement of the Companies Act) who is unlikely to have conflicts of interest with general investors; hereinafter the same).
2. The Exchange shall specify the necessary items for securing an independent director(s)/auditor(s) in the Enforcement Rules.

Rule 445-4. Composition of Independent Directors/Auditors

An issuer of listed domestic stocks shall make efforts to secure an independent director(s)/auditor(s) with consideration of the significance of a person(s) who holds voting rights in the board of directors being included in independent director(s)/auditor(s).

Rule 445-5. Preparation of an Environment for the Functioning of Independent Directors/Auditors

An issuer of listed domestic stocks shall make efforts to develop an environment where an independent director(s)/auditor(s) will fulfill the role expected thereof.

Rule 445-6. Provision of Information regarding Independent Director(s)/Auditor(s), etc.

An issuer of listed domestic stocks shall make efforts to provide its shareholders with information regarding an independent director(s)/auditor(s) and information regarding the independence of outside director(s)/auditor(s) as provided in Article 2, Paragraph 3, Item 5 of the Enforcement Rules of the Companies Act in a manner which contributes to the exercise of voting rights in the general shareholders meeting.

Enforcement Rules for Securities Listing Regulations (as of October 1, 2012)

Rule 436-2. Handling of the Securing of Independent Director(s)/Auditor(s)

1. The securing of independent director(s)/auditor(s) provided in Rule 436-2, Paragraph 2 of the Regulations shall be as prescribed in each of the following items.

    (1) An issuer of listed domestic stocks shall submit the "Independent Director/Auditor Notification" prescribed by the Exchange regarding independent director(s)/auditor(s) to the Exchange; and

    (2) An issuer of listed domestic stocks shall consent to the Exchange making the "Independent Director/Auditor Notification" prescribed in the preceding item available to public inspection.

2. In cases where any change occurs to the details of the "Independent Director/Auditor Notification" prescribed in the preceding paragraph, the issuer of listed domestic stocks shall, as a general rule, submit an "Independent Director/Auditor Notification" containing the changed details to the Exchange by a date two weeks before the occurrence of such change. In this case, such issuer of listed domestic stocks shall consent to the Exchange making the altered "Independent Director/Auditor Notification" available to public inspection.

Rule 211. Documents to Be Submitted Upon Listing Approval

4. Matters concerning corporate governance as specified by the Enforcement Rules as prescribed in Rule 204, Paragraph 12, Item 1 of the Regulations mean the matters specified in each of the following items; provided, however, that, in Item 5, this shall be limited to cases that initial listing applicants are issuers of domestic stocks:

    (5) Status of securing an independent director(s)/auditor(s) (including the matters provided in the following a. and b. when falling under the cases provided in such a. and b.) and;

    a. In cases where a person designated as an independent director/auditor falls under any of the following (a) through (e), such fact and the reason for designation as an independent director/auditor even in consideration of such fact:

        (a) A person who executes business, etc. of said company's parent company or fellow subsidiary (meaning a person who executes business (meaning a person who executes business as prescribed in Article 2, Paragraph 3, Item 6 of the Enforcement Rules of the Companies Act (Ministry of Justice Ordinance No.12 of 2006); hereinafter the same) or a person who executed business in the past; hereinafter the same);

        (b) A person/entity for which such company is a major client or a person who executes business, etc. for such person/entity, or a major client of such company or a person who executes business, etc. for such client;

(c) A consultant, accounting expert, or legal expert who receives large amounts of cash or other assets in addition to director/auditor compensation from such company (meaning, in cases where the entity receiving such assets is a group such as a juridical person or association, or other such group, a person belong to such group or having belonged to such group in the past.);

(d) A major shareholder of such company (meaning, in cases where such major shareholder is a corporation, a person who executes business, etc. of such corporation; the same shall apply hereinafter);

(e) A close relative of a person provided in the following i. or ii. (excluding persons of no significance):

(i) A person enumerated in the preceding (a) through (d);

(ii) A person who executes business, etc. of such company or its subsidiary (including, in cases where an outside auditor is designated as an independent director/auditor, directors who do not execute business, persons who were such directors, accounting advisors, and persons who were such accounting advisors,);

b. In cases where a person designated as an independent director/auditor falls under any of the following (a) through (c), such fact and its outline:

(a) A client of such company or a person who executes business, etc. for such client;

(b) A person who executes business, etc. for another company in cases where a person who executes business, etc. for such company is an outside director/auditor of such another company (meaning an outside director/auditor prescribed in Article 2, Paragraph 3, Item 5 of the Enforcement Rules of the Companies Act; hereinafter the same);

(c) A person receiving contributions from such company (meaning, in cases where the entity receiving such contributions is a group such as a juridical person or association, a person executing business, etc. or an equivalent person thereto)

Guidelines Concerning Listed Company Compliance, etc. (as of May 10, 2012)

(Measures against Violation of Code of Corporate Conduct)

5. In the case of a violation by a listed company of the provisions of Chapter 4, Section 4, Sub-section 1 of the Regulations, a decision on public announcement pursuant to the provisions of Rule 508, Paragraph 1 of the Regulations, as well as a decision on whether or not to impose the listing agreement violation penalty pursuant to the provisions of Rule 509 of the Regulations, shall be made in comprehensive consideration of (i) the matters prescribed in the classifications enumerated in the following (1) to (8) and (ii) the details, the background, the cause, and the actual state of affairs relating to said violation, as well as the state of implementation of measures such as a regulatory action taken by the Exchange in response to said violation and any other circumstances.

(3)-2 The provisions of Rule 436-2 of the Regulations

The status of a person(s) who is reported to the Exchange as being an independent director(s)/auditor(s) by the issuer of a listed domestic stock pursuant to the provisions of Rule 436-2 of the Enforcement Rules when such person falls under any of the following a. to e.;

a. A person who executes business of the parent company or fellow subsidiary of said company;

b. A person for which said company is a major client or a person who executes business for such person, or a major client of said company or a person who executes business for such client;

c. A consultant, accounting professional or legal professional (in the case of a group such as a juridical person or association, including persons belonging to such group) who receives a large amount of money or other asset other than remuneration for directorship/auditorship from said company;

d. A person who has recently fallen under any of a. to the preceding c.;

e. A close relative of a person enumerated in any of the following (a) to (c) (excluding those of insignificance);

(a) A person enumerated in a. to the preceding d.;

(b) A person who executes business of said company or its subsidiary (including directors who do not execute business or accounting advisors (when any of such accounting advisors is a juridical person, including any member thereof who is in charge of such advisory affairs) in the case where said company designates its outside auditor(s) as an independent auditor(s)); and

(c) Persons who have recently fallen under the preceding (b)

3. Principles of Corporate Governance for Listed Companies

Principles of Corporate Governance for Listed Companies

December 2009
Tokyo Stock Exchange, Inc.

Corporate governance is generally defined as the framework for disciplining corporate activities.

Most corporate activities have been undertaken principally with a view to generating revenue and thereby enhance the corporate value to shareholders. In expecting the listed companies to generate such performance on a continuous basis, it inevitably becomes necessary to motivate or monitor the management accordingly through a framework for disciplining corporate activities, namely corporate governance.

In other words, the appropriate operation of corporate governance for listed companies is a vitally fundamental demand for enhancing corporate value on a continuous basis, and the underlying aims of corporate governance are to provide an environment for such enhancement.

The profit-pursuing activities of enterprises are not fulfilled in modern economic society without complicated coordination of interests among various concerned parties (shareholders or investors, management, employees, suppliers, creditors, and local communities). As the areas of corporate activity are expanding, corporations face a growing need to take into account the values of different cultures and societies. As such, enterprises will have to engage in their profit-pursuing activities with a greater awareness of their social responsibilities, with greater transparency and fairness in accordance with market principles, while accepting full accountability to the entire economic community as well as shareholders and investors. The relationship with every concerned party bears an influence on corporate governance. From the perspective of the capital market, its focus centers primarily on relations between shareholders (including potential shareholders) and management.

The authority to execute the business of the company is delegated in large part to the management (representative directors, executive officers and directors, principal executives and the like), however such authority is based upon the confidence of shareholders, who ultimately provide the capital and bear the risks.

Shareholders usually empower the directors and auditors they elect with the authority to appoint, supervise and motivate management for the purpose of maximizing corporate value. Management is appointed by the resolution of the board of directors, which is given the authority to

execute daily routine work, and permitted to exercise broad authority subject to the supervision of the board of directors and board of company auditors. Directors, auditors, and the board of company auditors are elected by shareholders and have the obligation as prudent managers to fulfill the responsibilities mentioned above and the perform duties faithfully for the company and shareholders.

Any of the above can serve as a framework for governing the relations between shareholders and management. How to operate them effectively is the core issue of corporate governance.

Corporate governance, i.e., the framework for disciplining corporate activities, particularly those pertaining to the relationship between shareholders and management, is expected to fulfill various functions. The most important of these functions are as follows. Above all, it is crucial that the rights and interests of shareholders be protected and equally secured. Secondly, respecting the basic rights and interests of concerned parties other than shareholders (whose responsibilities have been increasing), and building smooth relationships with other such parties are crucial to the enhancement of a company's corporate value. In taking steps to effectively protect the rights and interests of all these interested parties, the transparency of corporate activities must be secured through the timely and accurate disclosure of information. Finally, the board of directors, auditors, and board of company auditors all hold key responsibilities and must fulfill all the duties expected of them.

These functions expected of corporate governance should be realized through the actual corporate governance policies adopted by a company. In reality, however, a specific model with a set of policies alleged to enhance corporate governance may not apply to every enterprise, but there are various combinations of policies suitable for individual enterprises. More important than adopting actual policies for corporate governance is the duty of individual companies to search for methods to better fulfill these functions in the light of cost-benefit relations to achieve the desired results.

The basic principles of a market economy hold that shareholders and investors evaluate these efforts and the state of information disclosure to make investment judgments and exercise their voting rights. Individual companies should review and improve their efforts on the basis of such evaluation.

In addition, the Principles of Corporate Governance apply to listed companies. However, with the recent development of forming a group of companies through the use of a holding company, etc., it is important for a listed company to ensure corporate governance of not only the parent company, but also the corporate group as a whole. Therefore, a listed company is required to make efforts so that corporate governance functions effectively as a corporate group as a whole.

The following points, as Principles of Corporate Governance, raise the issues to which

all companies should direct their attention, based on the expected functions of corporate governance.

1. Rights of shareholders

Corporate governance for listed companies should protect the rights of shareholders.

Corporate governance has been structured with the primary focus on shareholders. There are many stakeholders (concerned parties) other than shareholders who have relationships with companies. They include employees, creditors, suppliers, customers, and communities. Indeed, the continuous profit from corporate activities would not be generated without smooth relationships with these stakeholders. However, looking at corporate governance from the perspective of a capital market, the shareholders (i.e. the providers of the capital) lie at the core of corporate governance.

For the purpose of fulfilling their responsibilities as the element at the core of corporate governance, shareholders shall be authorized to exercise various rights in managing a company. This should include the right to participate and vote in general meetings of shareholders on basic decisions of the company, including elections and dismissals of directors and auditors, fundamental corporate changes, the basic right to share various profits such as dividends, and the special right to make derivative lawsuits and injunction of activities in contravention of laws, regulations and other rules. That these rights as established by law should be protected and secured is the underlying condition for the proper function of corporate governance in conjunction with shareholders' awareness of their rights.

Issues requiring attention

Listed companies shall direct their attention to the following issues in order to protect the rights of shareholders:

(1) Respect of shareholders' basic rights

a. Respect of voting rights

ⅰ. Development and improvement of an environment in which shareholders exercise voting rights appropriately;

ⅱ. Development and improvement of an environment in which shareholders are inclined to participate in general meetings of shareholders;

ⅲ. Mutual communication with shareholders at the general meetings of shareholders;

b. Return of profit to shareholders

(2) Due consideration to the infringement of rights of existing shareholders

a. Enhanced disclosure of information to shareholders in situations where specified shareholders have excessive control that is not in proportion to the ownership ratio, and the rights of other shareholders are substantially infringed.
b. Securing fair treatment of and enhanced information disclosure to shareholders in cases where the ownership distribution of the company is, or will be, changed.

2. Equal treatment of shareholders

Corporate governance for listed companies should ensure the equal treatment of all shareholders, including minority and foreign shareholders.

The equal treatment of all shareholders of the same class in proportion to their equity interests is an important element of corporate governance. Management, directors, auditors and controlling shareholders may find opportunities to abuse their positions to benefit themselves, and such activities are certain to cause disadvantages to investors and minority shareholders. The prohibition of abusive or fraudulent use of corporate assets or insider information by parties closely related to the company is an inevitable step to be taken both to protect investors and to maintain their confidence in the capital markets.

Issues requiring attention:

Listed companies shall direct their attention to the following issues in order to secure equitable treatment of shareholders:

(1) Development and improvement of a system to prohibit transactions against the primary interests of the company or shareholders through the abuse of concerned parties' positions such as officers, employees, and controlling shareholders;

(2) Enhanced disclosure of information to shareholders in cases where concerned parties conduct actions that are likely to damage the primary interests of the company or shareholders;

(3) Prohibition of special benefits provided to specified shareholders.

3. Relationship with stakeholders in corporate governance

Corporate governance for listed companies should help create corporate value and jobs through the establishment of smooth relationships between the company and its stakeholders and encourage further sound management of the enterprise.

That companies sustain and improve their competitive strengths and enhance their values through the pursuit of profit on a continuous basis is a principal interest common to shareholders, but this is the result of the provision of company resources by all stakeholders. Thus, the establishment of smooth relationships with stakeholders other than shareholders based on active cooperation and constructive criticism would be in the long-term interests of enterprises.

Issues requiring attention:

Listed companies should direct their attention to the following issues in order to establish smooth relationships with stakeholders other than shareholders:

(1) Cultivation of a corporate culture that respects the positions of stakeholders, and development of internal systems therefore;

(2) Timely and accurate disclosure to stakeholders of material information relating to stakeholders, and development of internal systems therefore.

4. Disclosure and transparency

Corporate governance for listed companies should ensure that timely and accurate disclosure is conducted on all material matters including the financial condition, performance results and ownership distribution.

Listed companies shall be obliged to conduct timely and accurate disclosure regarding corporate activities. Such disclosure is indispensable for appropriate investor evaluation of enterprises in the market, and concurrently for the appropriate exercising of voting rights by shareholders. For this purpose, shareholders require periodic, reliable and comparable information sufficient to evaluate the operational conditions of businesses by the management, and further timely disclosure regarding material events taking place during the intervals between periodic disclosures. Such disclosure shall be conducted simultaneously to ensure equal treatment of shareholders. Fair disclosure helps to secure the confidence of investors in the market and is an important means to prevent the abuse of insider information.

Issues requiring attention:

Listed companies should direct their attention to the following issues in order to conduct timely and accurate disclosure:

(1) Enhanced disclosure of quantitative information on financial conditions and operating results and enhanced disclosure of qualitative information that deepens the understanding of the management conditions of companies by investors ;

(2) Securing opportunities for investors to access information equally and easily;

(3) Development and improvement of internal systems to secure the accuracy and promptness of disclosure.

5. Responsibilities of Board of Directors, Auditors, Board of Company Auditors, and other relevant group(s)

Corporate governance for listed companies should enhance the supervision of management by the Board of Directors, Auditors, Board of Company Auditors, and other relevant group(s)(*1), and ensure their accountability to shareholders.

(*1) The term "Board of Directors, Auditors, Board of Company Auditors, and other relevant group(s)" refers to the organization responsible for supervising management, mainly the Board of Directors and Auditors or Board of Company Auditors.

The legal framework or basis for corporate governance permits the choice of a corporate auditors system or committees system. In either case, the Board of Directors, Auditors, Board of Company Auditors, and other relevant group(s) should evaluate whether the management (*2) has been accurately and efficiently executing business pursuant to their strategic guidance on strategies, and prevent the occurrence of conflicts of interest between the company and the management by reflecting on such evaluation prior to the election or discharge of management or the execution of decisions on compensation, and thereby fulfill their appropriate supervision responsibilities.

(*2) The term "management" means the persons recognized by the company to have actually been involved in the management of the company, including representative directors and executive officers, which in turn include representative executives and executives.

Issues requiring attention:

Listed companies should direct their attention to the following issues to ensure that the Board of Directors, Auditors, Board of Company Auditors, and other relevant group(s) sufficiently fulfill their responsibilities for management supervision and accountability to shareholders:

(1) Monitoring of the management by the Board of Directors and Auditors or Board of Company Auditors and other relevant group(s) (*3)

a. Organization of a Board of Directors, Auditors, Board of Company Auditors, and other relevant group(s) suitable for making an objective determination on the execution of business by the management;

b. Development and improvement of a system under which the Board of Directors, Auditors, Board of Company Auditors, and other relevant group(s) assume responsibility for supervising the management;

c. Development and improvement of an internal check and balance system under which the Board of Directors, Auditors, Board of Company Auditors, and other relevant group(s) make reasonable judgments on their compliance with laws and regulations and accuracy of business operation conditions.

(*3) The following measures shall be included in the monitoring of the management by auditors (or board of company auditors) from the viewpoint of strengthening the functions of auditors:

1. Maintain adequate human resources and infrastructure to support audits carried out by the auditors (cooperating with internal audit and internal control divisions for this purpose)

2. Appoint highly independent outside auditors; and

3. Appoint auditors with an in-depth knowledge of finance/accounting.

(2) Motivation for the management to maximize corporate value through positive convergence of management and company interests by appropriate means.

(3) Development and improvement of a mutual monitoring system by directors under which fulfillment of duty and integrity as prudent managers should be secured and under which illegal activities and inappropriate activities from the perspective of generally accepted views are prevented.

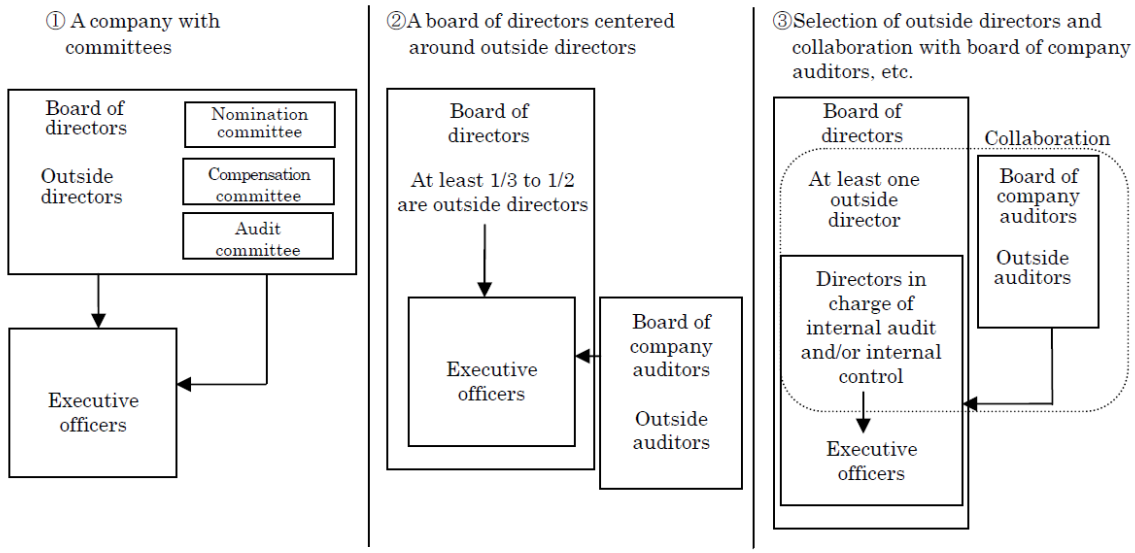
(Note) Structure of board of directors/auditors (board of company auditors), etc.

The following three corporate governance models have been proposed as those considered to be appropriate for many listed companies to secure the confidence of shareholders, investors, and others.

However, as described in the preface of the "Principles of Corporate Governance for Listed Companies", the best form of corporate governance varies depending on the structure, size, line of business and other aspects of each individual enterprise. Therefore, it is difficult to uniformly apply the same rule to all listed companies. In fact, there are various corporate governance structures.

Consequently, each listed company is required to sufficiently disclose the details of its corporate governance structure and the reasons for its selection of a particular structure.

The three models proposed in the "Report by the Financial System Council's Study Group on the Internationalization of Japanese Financial and Capital Markets" (publicized on June 17, 2009)



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