

Corporate Boards Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term

The Council of Experts Concerning the Follow-up of Japan's Stewardship Code
and Japan's Corporate Governance Code
Opinion Statement No. 2

I. Introduction

In response to the implementation of the Corporate Governance Code (“the Code”), more than 3,500 listed companies have explored the state of their corporate governance, and more than 2,500 companies or approx. 70% of Japan's listed companies have disclosed their responses to the Code as of December 2015.

According to these disclosures, roughly 80% of the companies listed on TSE First/Second Section reported that they complied with more than 90% of the Code's principles, with a high compliance rate for each Code principle. Furthermore, looking at specific details of disclosures and explanations required by the Code, many companies intend to communicate their corporate governance initiatives to stakeholders in a sincere and easy-to-understand manner. In sum, in the wake of the implementation of the Code, corporate efforts aiming at enhancing corporate governance can be widely seen in Japan.

In terms of the governance efforts related to corporate boards, discussions have focused on their oversight function, and consequently significant changes have been made. Almost half of the companies listed on TSE First Section have appointed two or more independent directors, and the boards of some companies have adopted the monitoring model, aiming at further strengthening their oversight. On the other hand, partly because the Code was implemented just recently, as shown by the fact that many listed companies reported they would start working on the evaluation of the board's effectiveness in the future, efforts are still underway concerning the composition, operation, evaluation and improvement of the board in response to the Code. In addition, verification of companies' implementation status of the Code through dialogue between investors and companies in accordance with the Stewardship Code is still in progress.

With the intention to contribute to the continuing efforts of companies and their dialogue with investors, taking into consideration the companies' responses to date to the Code, this Opinion Statement offers perspectives concerning the Code's principles as they relate to corporate boards, addressing issues which are considered important now for companies to achieve genuinely effective corporate governance, not just formalistic responses to the Code.

II. Changing Business Environment and the State of the Board

While the environment surrounding Japanese companies has been significantly changing due to globalization, the progress of technological innovation, population decline and the rapid aging of society, and increased attention to social and environmental issues, management challenges facing companies have become increasingly complex, and it has been pointed out that many Japanese companies have not always been able to address such changes promptly.

In order for Japanese companies to achieve sustainable growth and increase their corporate value over the mid- to long-term while responding to changes in the business environment and increasingly complex business challenges, it is important that management led by the Chief Executive Officer (CEO) constantly makes far-seeing and correct managerial decisions. In this sense, the appointment/dismissal of the CEO by the board is the single most important strategic decision for companies, and thus objectivity, timeliness, and transparency are strongly desired to render appointment/dismissal procedures appropriate.

In addition to the appointment/dismissal of CEO, the board has important roles and responsibilities in establishing business principles, setting strategic direction, establishing an environment that supports appropriate risk-taking by senior management, and conducting effective oversight. The board is expected to exercise leadership in the company together with the management (Principles 4.1 to 4.3). In order for the board to secure its independence and objectivity, adequately respond to the business environment and business challenges, and sufficiently exercise such leadership, the board is expected to be composed in such a way as to ensure it has the qualifications and diversity necessary for addressing business challenges, and enhance strategic discussions, such as business strategies and the appointment and dismissal of senior management, in line with such strategies.

Furthermore, from the perspective of adequate responses to business challenges, etc., the board is expected to continuously evaluate its effectiveness and disclose/explain the evaluation results, realize a PDCA (plan-do-check-act) cycle, and constantly aim at enhancing the board's functions.

1. Appointment/Dismissal of Chief Executive Officer (CEO) (Supplementary Principles 4.1.3, 4.3.1, etc.)

Under intensifying competition as well as discontinuous and volatile changes in the business environment, the CEO's ability determines the fate of a company. The appointment/dismissal of the CEO is thus the single most important strategic decision for companies seeking sustainable corporate growth and increased corporate value over the mid- to long-term, and such procedures require objectivity,

timeliness, and transparency (Supplementary Principle 4.3 1).

- (1) Some argue that what Japanese companies lack most are talented executives qualified for the position of CEO. To cope with such a problem, it is essential for companies to work on CEO candidate talent development as well as the actual appointment of the CEO by investing sufficient time and resources from a mid- to long-term perspective. Furthermore, when establishing and implementing a succession plan (Supplementary Principle 4.1.3), it is necessary to have in place procedures to secure objectivity, timeliness, and transparency, and not rely on intransparent procedures that place priority only on internal logic.

Some Japanese companies have been undertaking various efforts from this perspective.

[Examples of efforts]*

- Conduct adequate discussion of the (optimal) qualifications for the future CEO based on the company's mid- to long-term strategy and share the outcome of the discussion broadly within the company.
- The board establishes a policy for developing candidates qualified for the position of CEO, and such candidates are developed as follows: select multiple CEO candidates from an early stage, assess them while having them gain necessary business experience, and replace candidates as appropriate.
- Establish and implement procedures where multiple CEO candidates are introduced to the board, which in turn, assesses the qualifications of the candidates using sufficient and appropriate time; such candidates are not only company insiders, but also could be outsiders.
- Use nomination committees and optional advisory committees on nomination in order to get the full participation of independent directors (Supplementary Principle 4.10.1) and conduct executive sessions (meetings consisting solely of independent directors (Supplementary Principle 4.8.1)).

- (2) In cases where problems are found with the CEO after conducting appropriate evaluation of the company's performance, it is necessary to set a mechanism that makes it possible to dismiss the CEO. In this regard, it is important that the board sufficiently secures its independence from the management as well as its objectivity so that the board can dismiss CEO in a timely and appropriate manner.

* The "examples of efforts" that are introduced in this opinion statement give an indication of the examples that have been suggested for reference in follow-up meetings as important for ensuring the effectiveness of the Code. These examples do not constitute new formal rules.

2. Board Composition (Principle 4.7 to 4.9, 4.11, etc.)

In order to fulfill its required roles and responsibilities while coping with the changing business environment and increasingly complex business challenges, it is important that the board has the necessary qualifications and diversity as well as independence and objectivity.

- (1) With regard to the current implementation status of board composition (Principle 4.11), there are companies making efforts to improve the balance of qualifications and diversity of their board members depending on the business/stage of the company, business environment, and business challenges. Such efforts are expected to facilitate sustainable corporate growth and increase corporate value over the mid- to long-term.

[Examples of efforts]

- Appointment of specialists in fields that the company has positioned as growth fields.
 - Appointment of people with management experience and insights in fields that are different from the company.
 - Appointment of global talent for international business expansion.
- (2) The number of independent directors appointed by Japanese companies has seen steady growth. In more than 10% of the companies listed on TSE First Section, at least one-third of board members are independent directors. Stakeholders are increasingly shifting their focus from the number of independent directors to the qualifications and diversity of the board members. In response to the business environment and business challenges, companies are expected to appoint more independent directors who are qualified to actively contribute in fulfilling the roles and responsibilities of the board, including discussions with respect to business strategies for increasing mid- to long-term corporate value as well as the appointment and dismissal of senior management, by making best use of directors' insights and professional backgrounds which cannot be found within the company.
 - (3) There are companies that are making even further efforts to ensure greater independence/objectivity of their boards. It is expected that such efforts will increase the independence and objectivity of boards.

[Examples of efforts]

- Use optional advisory committees for nomination and compensation, etc., especially at companies with *Kansayaku* or Supervisory Committee structures (Supplementary Principle 4.10.1). Such advisory committees

should consist of a majority of independent directors and be chaired by an independent director.

- Separate the roles of CEO and Chairperson of the Board.
- Drawing on US practice, establish a lead independent director in order to have an effective division of roles between the board and management team.
- Have independent directors take the initiative in the appointment process of independent directors.

- (4) In order for the Audit Committee or Supervisory Committee (hereinafter “Audit Committees”) to appropriately fulfill their important roles and responsibilities such as operational auditing and accounting auditing, Audit Committees need to secure their independence and objectivity. Appointing an independent director as the committee chairperson contributes to strengthening the independent and objective standpoint of Audit Committees.
- (5) Whether the independence and objectivity of the board and the Audit Committees can be secured and whether they can sufficiently exercise their functions often depends on CEOs’ intention to make use of the characteristic of the board and Audit Committees, which is “the independent and objective standpoint”, for their managerial decisions. In this sense as well, the appointment/dismissal of CEO by the board is an important business challenge for companies.
- (6) The Code seeks explanations on companies’ views with respect to the composition of the board as well as disclosures of policies/procedures concerning the nomination of director candidates and individual-level explanations of the appointments of senior management and the appointments and nominations of directors (Supplementary Principle 4.11.1. and Principle 3.1(iv) (v)). It is important that such disclosures and explanations clearly and specifically communicate information regarding how each company’s board is composed to fulfill its expected roles in response to the business environment and business challenges.

3. Board Operations (Principles 4.8, 4.10, 4.12 to 4.14, etc.)

In order for Japanese companies across the full-range of their corporate groups to address changes in the business environment and increasingly complex business challenges, it is important that boards enhance their discussions on strategic directions and appropriate evaluation of corporate performance, etc.

- (1) The following board-level discussions should be enhanced, given that the board oversees the management and exercises the leadership necessary for the

company together with the management, while coping with the changing business environment and increasingly complex business challenges:

- Setting a corporate strategic direction and specific business strategy and business plans in accordance with such a direction.
- Appropriate evaluation of corporate performance and review of business strategy, etc. and decisions on the appointment/dismissal of and compensation of senior management in accordance with such evaluations.
- Establishing internal control/risk management systems.

(2) In order to enhance such discussions within the board, it is necessary to conduct board meetings flexibly and creatively, for instance, by clarifying key points to be the focus of discussion, reducing the number of agenda items, and securing sufficient time for deliberation (Supplementary Principle 4.12.1).

[Examples of efforts]

- Clarify points to be discussed and key issues to be addressed with respect to agenda items in order to solicit opinions of board members in an effective manner. The Board Chairperson is expected to exercise appropriate leadership of this process.
- With regard to agenda items that are strategically important to the business, the board carries out discussions regardless of the amount of money involved, while delegating authority on operational execution to management in order to reduce the number of issues that come before the board.
- Introduce ‘matters to be discussed’ in addition to ‘matters to be reported’ and ‘matters to be resolved’ as agenda items to board meetings, and have substantive discussion on important issues before voting on them as board resolutions.
- Ensure that management and financial information necessary for discussing mid- to long-term strategies is reported to the board in a timely manner.
- Secure adequate time for deliberation for each agenda item so that effective discussions can occur for each agenda item.
- Enhance and strengthen the organizational and personnel framework to support appropriate management of the board.

(3) It has been pointed out that, in cases where internal directors have operational responsibilities, they frequently take part in the board only from the viewpoint of their operational roles. Internal directors must fully understand that their role is not limited to the execution of their own operational

responsibilities and includes conducting oversight of the totality of a company's business, including the oversight of the activities of other board members with operational roles.

- (4) It is necessary to establish an environment that enables independent directors to contribute to board discussions on setting strategic directions.

[Examples of efforts]

- Report and provide information to independent directors flexibly and creatively.
- Provide independent directors with appropriate training opportunities in an appropriate timeframe (e.g., upon or after assuming a directorship) and as required by the circumstances of the company (Principle 4.14).
- Exchange information between independent directors and full-time *kansayaku* and other persons who are deeply familiar with the workings of the company.
- Conduct executive sessions.
- Solicit agenda items in advance for board meetings from independent directors.

- (5) As part of the roles and responsibilities of independent directors, it is important to represent views of minority shareholders and other stakeholders in the boardroom (Principle 4.7 (iv)).

- (6) Whistleblowing is the final defense in preventing corporate scandals. In order to ensure that such a whistleblowing system works well, it is appropriate to establish a system where an act of whistleblowing is reported to a point of contact that is independent of the management (for example, outside directors and/or outside *kansayaku*).

4. Evaluation of Board Effectiveness (Principle 4.11)

It is essential to evaluate effectiveness of the board as a whole, including whether effective efforts are being made to improve qualifications and diversity of board members as well as board operations, and continuously reflect such results in the next steps of the board.

- (1) At the end of May, one year will have passed since the implementation of the Code. Accordingly, each company is expected to properly evaluate the effectiveness of its board composition and operations, etc. Upon making an evaluation, it is expected that companies will make various choices in their evaluation efforts depending on their specific circumstances, but primary

importance should be placed on an honest evaluation of the board by each board member.

[Examples of efforts]

- Conduct an interview with each director to generate a self-evaluation of his/her contributions to the board, as well as whether he/she considers that the board as a whole has sufficiently fulfilled its roles and responsibilities, and what challenges the board has to overcome in order to be more effective.
 - Secure active involvement of independent directors by using Nomination Committee and/or meetings consisting solely of independent directors.
 - Evaluate operations, etc. of each committee under the board, including optional committees.
 - As in the UK, include the viewpoints of external evaluators in evaluations in order to secure a higher level of independence and objectivity, and disclose the name of the external evaluator in order to clarify whether there are any conflicts of interest.
- (2) In order to properly evaluate the effectiveness of the board, it is first necessary to clarify the roles and responsibilities of boards in seeking sustainable corporate growth and increased corporate value over the mid- to long-term. In making an evaluation after such clarification, it is also necessary to substantively evaluate whether board composition and operations, etc. are effective for such roles and responsibilities.
- (3) When the board implements a PDCA cycle for improving the qualifications and diversity of its members as well as board operations, it is important to disclose and explain to stakeholders its efforts and the results of its evaluations of board effectiveness in an easy-to-understand manner.

III. Closing Remarks

Many Japanese companies are now working toward their general shareholders meetings in June by examining director candidates and preparing for the evaluation of the board effectiveness. We hope this Opinion Statement will be used by them as a reference. We expect that each company will create a PDCA cycle toward enhancing effectiveness of the board through systematically cultivating and nominating directors with qualifications and leadership skills, securing the independence and objectivity of the board through its composition, and implementing a proper evaluation of the board.

In closing, we expect that the sincere efforts of Japanese companies to enhance their corporate governance will lead to the achievement of sustainable growth and

increased corporate value over the mid- to long-term, thus generating a virtuous cycle for the Japanese economy.