Opinion Paper regarding the Drafting of the Corporate Governance Code
(For the 3rd Council of Experts)

September 30, 2014
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1. Confirmation of the Underlying Issues

The current drafting of the Corporate Governance Code is based on the issues raised in the revised Japan Revitalization Strategy “Restoring Japan’s Earning Power” which questions and aims to change the status quo. The current situation is one where many Japanese listed companies have lagged behind their US/European counterparts in terms of growth and earning power, despite their outstanding technological competence and *genba* power (on-site capabilities).

Accordingly, the fundamental aim of drafting this Code is to create an environment where listed companies in Japan can increase their ‘earning power’ (in terms of both growth and profitability) on a long-term sustainable basis. Therefore, the **strengthening of ‘offensive governance’ is required together with ‘defensive governance’** which has dealt with the prevention of scandals such as accounting fraud in the past.

The essence of ‘offensive governance’ is **to have reasonable restraining powers (e.g. power to appoint/dismiss management) to allow the strict monitoring of management to see whether they are increasing long-term sustainable corporate value**. Management should overcome internal/external resistance and continuously make necessary changes in order to enhance fundamental competitiveness whilst also taking adequate risks at the appropriate time despite changing business climates and maintaining a harmonious balance between the values of various stakeholders including the wider society.

Consider the company auditor system as an example. We must rightly recognize that this system has played an important role in ‘defensive governance.’ At the same time, it is essential to understand the practical limitations of this system and when striving for ‘offensive governance’ to increase ‘earning power’ we should incorporate measures which can compensate for such limitations into the Code. Specifically, **for companies with Board of Company Auditors, it is essential and important to include detailed description about how the functions of outside directors can be reinforced (this**

includes the division of roles and cooperation with company auditors, especially outside company auditors).

With regards to the adoption of the 'comply or explain' rule for outside directors in the recent amendment of the Companies Act passed as part of the Japan Revitalization Strategy initiative, it is expected that the Ordinance of the Ministry of Justice will stipulate that "the presence of outside company auditor does not provide sufficient grounds to justify exemption from having outside directors". This is stipulated with the same purpose and intentions as the reasoning provided above.

2. The Applicable Scope of the Code (I would like to comment because I left mid-way through the previous discussion)

The applicable scope of the Code should certainly try to **cover as many listed companies as possible.** On the other hand, as long as the Code aims to improve the status quo, **the priority should be to establish a Code with high standards. This means that the standard of the Code should never be lowered to extend the applicable scope, as this will go against the whole purpose of the code.**

There are approx. 3,500 listed companies in Japan and these represent the top 0.14% elite companies amongst the approx. 2.4 million stock companies across the country. Therefore, it is intrinsically fair that such elite companies are required to have a high level of corporate governance, given their highly public nature. Therefore, the Code should first be drafted to a high standard and naturally applied to the companies listed on the first section of the Tokyo Stock Exchange (approx. 1,800 super elite companies, accounting for just 0.08% of all stock companies), and to as many other listed companies as possible.

If we do have to exclude some listed companies from the scope of the Code to ensure a high standard, a mechanism for these companies to voluntarily comply with the Code and disclose such compliance should be adopted.

3. Rights and Equality of Shareholders

(1) General

One of the important objectives of the Corporate Governance Code framework is to protect shareholders' rights and facilitate the exercise of such rights. However, it should not uphold shareholder capitalism which protects shareholders only pursuing short-term profits. To prevent such short-term shareholders abusing the Code, the Code should stipulate that if is in fact the right of long-term shareholders who support sustainable corporate growth which need to be protected.

However, management should not use the fact that the interest of short-term shareholders do not need to be protected as an excuse to give up constructive and collaborative dialogue with shareholders. On the contrary, the Code should be drafted to encourage dialogue with shareholders. For that purpose, management should try to eliminate information asymmetry between them and shareholders.

(2) The Exercise of Voting Rights

The exercise of voting right is the most fundamental and important right for shareholders, and also should be regarded as "Kyoekiken" (the right for the common interest) which becomes the ultimate bulwark for corporate governance. The board of directors should be held responsible for the effective exercise of such rights.

In order to achieve this, in practical terms, the date of the general meeting of shareholders should be set on a non-peak day.
It is also necessary to dispatch the convocation notice of the general meeting of shareholders no later than 20 business days prior to the meeting. Postponing the dispatch of the convocation notice to secure time for an audit, an activity aimed to protect shareholders, defeats the whole purpose.
Furthermore, companies should make efforts not only to dispatch the convocation notice earlier, but also to disclose sufficient information to shareholders. For example, websites can be used for early information disclosure, or Securities Report can be released prior to the general meeting of shareholders.

When we consider how the remunerations for directors, officers and management should be resolved at general meetings in the current social climate in Japan, the important and effective issue that needs to be addressed is how the objectivity and transparency of the decision-making mechanism is secured. For companies with board of company auditors or audit and other committees, a remuneration

committee with a majority of outside directors should be mandatory (if there are equal numbers of outside and internal directors, the position of chairperson who makes the final decision in case of a tie vote should be assumed by an outside director). This committee should have real powers to make the ultimate decisions. Moreover, the policy and mechanism used to determine remunerations of directors and officers should be disclosed to the shareholders.

(3) Cross-Shareholdings

Cross-shareholdings between listed companies (including those by an unlisted company within a listed company's group) are often criticized for weakening corporate governance. However, **the real problem is not the cross-shareholdings itself, but whether it is rational in terms of costs and benefits to increase long-term sustainable corporate value.** For example, a typical case where cross-sharing is considered rational is when a main bank temporarily holds shares in a company which has gone into DIP (Debtor In Possession) proceedings for the purposes of revitalization.

Except for this specific case, cross-shareholding is generally based on some type of trade relationship, and the benefit to the company is to strengthen, maintain and stabilize this relationship by becoming a long-term shareholder of its counterpart company.

However, this structure is based on the implicit assumption that these companies will become "silent majority shareholders", and therefore there is a high risk that corporate governance will lose any substance. Voting rights are "Kyoekiken" and therefore entails obligations and responsibilities towards all other stakeholders of the company, including minority shareholders. In that sense, the responsibilities and risks associated with holding a significant number of shares for policy reasons are not small. Moreover, if a company owns a significant numbers of shares based on a significant interest unique to the specific shareholder (i.e. a trade relationship), there is a risk of causing significant conflict of interest vis-à-vis interests of shareholders in general, especially with minority shareholders.
In fact, the cases of failures of listed companies in the past, including the airline company case I was involved with, prove the above. Even when the deterioration of financial results is apparent and management have repeatedly committed errors in their decision-making, almost all owners of "policy stocks" voted in favor of the companies'

proposals including those concerning the appointment of directors at the general meetings of shareholders held directly before the company failure.

Moreover, unless the price of the counterpart company's shares rises favorably, the cross-shareholders have to bear capital costs for holding such dormant capital, and face stock price fluctuation risks.
As listed companies raise funds from a wide range of public shareholders, and use the funds for their businesses, it can be said that they have a fiduciary duty similar to institutional investors. Accordingly, in order to increase medium- and long-term returns for shareholders, we should regard that rules similar to those of the Stewardship Code are potentially in force and therefore, the associated costs and risks are not small.

Thus, **to fulfill their fiduciary duty, companies are responsible for providing clear and specific explanations and disclosures around why the benefits of cross-shareholdings in question will outweigh the costs, thus increasing long-term sustainable corporate value. In addition, companies should determine and disclose the policy for announcing the voting activities and voting results concerning such "policy stocks."**
Also, **when a shareholder of "policy stocks" exercises its voting right (which is a "Kyoekiken"), it should provide an explanation both to the public shareholders of its own company and the investee company about the rationality and validity of the exercise regarding the potential conflict of interests (i.e. conflict of interest between the minority shareholders of the investee company and its own interest from the trade relation).**

(4) Equal Treatment of Shareholders

As mentioned earlier, when a shareholder exercises its "Kyoekiken", in other words, exercises its voting rights which could influence the interests of other general shareholders and stakeholders, this shareholder should be held responsible for the sustainable growth of the company which is in fact the common interest. In particular, large shareholders should not harm the interests of other minority shareholders by pursuing short-term profits.

Therefore, **when large shareholders exercise their voting rights, which are "Kyoekiken", they should acknowledge that they are directly held responsible for**

the interests of other minority shareholders. Furthermore, if a trade or exercise of voting rights between the company and a major shareholder may cause conflict of interests with minority shareholders, attention must be paid not to sacrifice the interests of minority shareholders.

4. Relationship with Stakeholders

The Corporate Governance Code should support the long-term sustainable growth of companies. If this premise is upheld, there should be no ultimate conflict of interest between shareholders (who contribute to the long-term growth) and other stakeholders such as employees, customers, business partners, and communities.

Therefore, **in the interest of increasing long-term corporate value, the Code should stipulate that companies should give consideration to the interests of other stakeholders who are not shareholders.**
Furthermore, companies should establish a mechanism enabling stakeholders including employees, to have access to the board of directors as well as independent directors.

On the other hand, although I believe that the issues regarding the "ensuring diversity within a corporate structure, including the better use of female talent," should be included in the discussions surrounding the composition of the board of directors, this remains a significant challenge. There is a lack of progress in the diversification of Japanese companies and this is one of the reasons why they have lost their competitiveness.
Therefore, when selecting candidates for directors, companies should be required to consider the diversity of directors, in terms of male-female ratio, age, nationality, professional background, skills and other factors.

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