Statement for the 30th Council of Experts Concerning the Follow-up of Japan’s Stewardship Code and Japan’s Corporate Governance Code

2 June, 2025

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- The management and governance models that have been adopted in the last 10 years since the introduction of CG Code are models that promote prompt and bold management by increasing the degree of separation between supervision and execution and by transferring significant authority to the executives, while the main responsibility of the board of directors is to supervise the executives.

- In many companies, the ratio of outside directors exceeds 30%, and the number of companies with audit and supervisory committees has increased significantly. Companies are formally moving toward this model. However, the reality is that the board of directors does not function effectively as a “supervisory” board, or the majority of companies, directors, and managers do not understand the meaning of “supervision”.

1. The purpose of supervision and hollowing out of the supervisory power due to the lack of substance of the "appointment"

・ First of all, the fact that the board supervises the executives means that the board is the boss of the top management. This should be made clear in the CG Code.

・ Therefore, the core of supervision is the right of personnel management related to the top management and directors. Without this right, supervision is nothing more than playing house. Substantial delegation of authority to the executives and strong supervision based on the right of personnel management to the top executives are mutually indispensable. In this sense, with less than 5% of companies with a statutory nomination committee, the functions to appoint executives in most companies are left to the optional nomination advisory committee, and in most cases, their functions remain limited to the ratification of proposals by executives. The root of recent governance scandals, or the root of problems pursued by activists, stems from the sloppiness of nomination. The Code should clearly state that, as an item to be complied with, the optional nomination advisory committee should have the identity, leadership, responsibility, and accountability equivalent to those of the statutory nomination committee. The nomination issue is too heavy to rely solely on the motivation and patience of the members of optional nomination advisory committee.

・ In particular, the hollowing-out of the right to appoint, i.e. the hollowing-out of the right to supervise, is a serious problem in companies with audit and supervisory committees, which can transfer significant authority to executives. It is indeed symbolic that a certain media company has recently adopted this model. The CG Code should strictly require companies adopting this model to take measures to ensure the effectiveness of the optional nomination advisory committee (please refer to my contribution to the Bulletin of the Japan Association of Corporate Directors*).

・ After all, in a governance structure with separate supervisory and executive functions, the supervisory function of the board is not a close involvement of the executives in the management process, but it is expected to:

(i) discuss and share basic management policies between both parties

(ii) manage the results of whether the executives are functioning in light of the basic corporate policy and encourage correction if it is not in line with the strategy. If it is found difficult to correct, the executives shall be replaced.

In other words, it is a results-based governance model with supervision building on human resources management.

・ Of course, it is useful for outside directors to provide advice on execution matters based on their knowledge, and it is good to make contributions. However, this is not an essential role of outside directors. The first is the exercise of supervisory authority, i.e., the appropriate exercise of personnel management authority over the top management based on the accountability in both aspects of "growth-oriented governance" and "compliance-oriented governance." This should be clearly stated in the CG Code. If you think you cannot achieve this, you should not be appointed as a director, whether internal or external. If you think your knowledge is insufficient, you should study and train yourself appropriately.

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・ In fact, with the decline in strategic shareholdings, which used to be "silent ruling party shareholders," and the increased activity of activists, resolutions to appoint directors are hotly debated at AGMs, and acquisition proposals without consent are becoming routine. As a result, boards, and outside directors in particular, must make tough decisions about control and the outcome of management personnel decisions. Each of us should be strongly aware that we are entering an age in which we may be exposed to not only reputational risk but also huge litigation risk if we make a wrong judgment in response to this with incomplete knowledge. We believe that disclosure of the minimum necessary knowledge, qualifications, and training record as a director regarding the suitability of candidates should be required at least for proposals for the appointment of directors.

- There are other problems with current practices in the context of the hollowing-out of supervisory powers.

- First, most companies are taking a box ticking approach to so-called board evaluation. They often evaluate whether the board conducts various checks in detail. Many of them focus on process management items and are not suitable for the model of separation of supervision and execution. It is a problem that many of them are based on the conventional governance model without separation of supervision and execution, that is, the assumption that the agendas of the executive committee and the board overlap. In this regard, we urge both companies and consulting firms that supported the evaluation to reflect on the issue.

- Another point is that the secretariat of the board is more a servant of the executives than the board of directors, i.e., it aims to smoothly pass proposals submitted by the executives to the board on behalf of the top executive officer. Of course, the smooth running of board meetings is important from the viewpoint of meeting productivity, but it should also be clearly stated in the CG Code that the board is the boss of management and that the secretariat should serve the board and stakeholders and not the top executive.

2. Two hollowing-out issues caused by the audit and supervisory committee model

- The audit and supervisory committee model is basically a "delegation audit" model in which accounting audits are left to audit firms and operational audits are left to internal audit departments, with the audit committee overseeing their proper functioning. This is also a "compliance-based governance" model with separate supervision and executives, i.e. indirect governance.

- However, many audit committees have simply shifted from the conventional board of auditors. As a result, there is a risk of two hollowing-outs: a hollowing-out of the board of directors and a hollowing-out of the audit function.

- First, there are many cases where persons who were originally outside auditors become a member of the audit and supervisory committee, and there are not a few cases where full-time auditors become full-time members of audit and supervisory committees.
  In such cases, they lack self-awareness as directors and do not play a sufficient role as directors who should exercise supervisory rights on both sides of growth and compliance. And in many

cases, they do not interfere with the basic policy of management, which is precisely the highest level of management issues. As a result, a significant portion of the function of the board of directors have been hollowed out. It should be clearly stated in the CG Code that members of audit and supervisory committees are also board members and should fulfill their duties as members of the board, which is the highest management body.

- Secondly, regarding the relationship between the audit committee and the executives, the three-line audit systems on which this model functions are often extremely weak.
  The audit committee, which differs from a company with audit and supervisory board in that it does not conduct audit visits on its own, is particularly at risk of having weak control over operational audits and risk management. The media scandals are a classic example of such a vulnerability in that the audit committee was unaware of any material risks that were squeezed in the first line. Therefore, it is necessary to enhance the three-line audit system and change the position of the third line of executive officers to a higher position comparable to the CEO, such as CAE (Chief Audit Executive), which is a global standard, instead of the general manager-level position of the head of the internal audit office. It is also necessary to establish a structure in which a parallel double report line is formed between the CEO line and the audit committee line, and the first line (execution sites) and the second line (compliance and risk management departments) also have a report line for CAE in addition to the normal report line in the execution department. This point should also be included in the CG Code.

3. Need to raise awareness of the causal story of sustainable disclosure

- While financial information disclosure is the disclosure of past performance, there is little understanding of sustainable disclosure, which centres on human capital disclosure, and the fact that the main purpose of non-financial disclosure is to disclose information or stories related to sustainable increase in corporate value for the future. In other words, sustainable disclosure should be a causal cyclical structure in relation to future financial information.

- In other words, it presents an equity story related to human capital. In terms of PBR=ROExPER, financial information discloses ROE (current earnings power), and sustainable information discloses PER (future growth potential).

- As a result of a lack of understanding, the majority of sustainable disclosures consist solely of a variety of numerical values, similar to financial disclosures, or consist only of standard and superficial descriptions.

- As a first step, in sustainable disclosure, it should be enlightened by clarifying in the CG code that the causal story, especially the equity story related to human capital, should be shown.

*"Corporate Governance" Vol. 18, April 2025-issue, published by Japan Association of Corporate Directors.
Kazuhiko Toyama, *Goals for institutional design and steps for reform*,
https://www.jacd.jp/news/column/serialstory/250515_content-9.html