

# Guidelines on Outside Directors and *Kansayaku*

June 30, 2014

Corporate Governance System Study Group

The Ministry of Economy, Trade and Industry

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## **1. Preamble**

### **1.1 Basic Principles of Corporate Governance**

As Japan's social and economic structure faces drastic changes including the development of globalization, declining birth rate, and aging population, it is indispensable to discuss and deepen the study of an internationally understandable and socially and economically desirable corporate governance system on a consistent basis to ensure continuous growth and sustainable prosperity in the future.

Corporate governance shall accomplish the following:

- (1) Achieve long-term performance,
- (2) Put in place a mechanism to prevent misconduct and unsound events at the company from occurring.

In addition, it is also important to

- (3) Present, in a transparent manner to investors, (1) and (2) above, so that they can understand them easily.

Companies shall develop their management strategies to enhance corporate value according to their business models by taking into account the surrounding management environment including the situations and risks they face. Under such management strategies, companies shall consider, on an ongoing basis, corporate governance system including structure of corporate governance and roles and composition of the board so as to enhance corporate value. The following points may be raised, as example of the perspectives with which to consider such topics:

- (1) What are the situations and risks the companies faces? What does the company make of their management strategies? Given such considerations, what is the expected function of the board (for instance, a monitoring function specializing in supervision, an operation function with emphasis on decision on the execution of the operations, or a hybrid of both functions)?
- (2) What type of structure of corporate governance is selected?
- (3) Considering the role of the board, what kinds of members are desirable as its constituents? What kind of support system would be in place for different

members of the board including outside directors and outside Audit & Supervisory Board Members (*Kansayaku*)<sup>1</sup>?

- (4) Can companies now disclose, to investors, the format of their own corporate governance systems so that investors understand them easily?

## **1.2 Gist of this Guideline**

This guideline indicates matters that are required or recommended to ensure an excellent corporate governance structure. It focuses on matters relating to non-executives including outside directors and outside Audit & Supervisory Board Members (*Kansayaku*) and the support system for them.<sup>2</sup> By implementing these matters Japanese listed companies may gain confidence from within Japan and overseas. Such matters are based on Best Practices of the Japanese companies that the study group learned through its interviews with them. We also referred to the corporate governance codes of Europe countries.

## **1.3 Background of Examination**

In Japan, corporate governance came to be reinforced steadily. For instance, the Tokyo Stock Exchange (hereinafter referred to as “TSE”) revised its Securities Listing Regulations in 2009. Following the revision, the adoption of independent officers was developed. However, triggered by misconduct at some listed companies, the Japanese corporate governance system has been subjected to criticism in Japan and overseas.

With this background, the TSE asked for public comment concerning the independent

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<sup>1</sup> [Translation Note : Many Japanese companies currently adopt the term “Corporate Auditor” as the English translation of “*Kansayaku*”. However, use of the word “Auditor” may cause confusion with external accounting auditors or employees in charge of internal audit. In addition, (i) they not only audit financial reports but also check and monitor management activities in general, (ii) Each member can individually exercise his/her strong power of investigation of the company’s activities and of enjoinderment of illegal acts, (iii) A member has the legal obligation of attending the board of directors meeting and expressing his/her opinion. Considering such functions and powers, we use the word “Audit & Supervisory Board Members (*KANSAYAKU*)”]

<sup>2</sup> To enjoy sound and sustained growth, it is most important for executives to fulfill their duties appropriately. As a matter of course, we need to bear in mind the division of roles and links between executives when discussing how the supervising body including non-executives is. Therefore, this guideline also states basic matters concerning the board and executives.

officer system. In May 2012, The TSE revised its Securities Listing Regulations to enhance the disclosure of information regarding independent officers.

Additionally, the Japanese Ministry of Justice's Legislative Council Subcommittee on the Companies Act deliberated a revision to require companies to adopt an outside director. In September 2012, the Legislative Council adopted the resolution to the effect that companies with no outside director shall state, on its business report, the reason why it is not appropriate to have an outside director. The Legislative Council also adopted a supplementary resolution on the revision of the Securities Listing Regulations to require a listed company to make an effort to secure one independent director. Immediately upon making these resolutions, the Legislative Council submitted the recommendations to the Minister of Justice.

Subsequently, the Cabinet decided to approve the Bill for the Act for Partial Revision of the Companies Act in November 2013. In this Bill, directors of companies are required at annual shareholders' meeting to provide explanations on the reason why it is not appropriate to have an outside director. Supplementary provisions were added to the effect that the corporate governance system is to be reviewed two years after the revised Act takes effect (taking into account the status of selected outside directors and other matters on social and economic transformations). According to such a review, some measures such as a requirement to secure outside directors are to be taken whenever deemed necessary. This Bill passed into law on June 20, 2014

Based on the above Supplementary Resolution, the provision, in which listed companies shall make effort to secure at least one independent director, was added to the Securities Listing Regulations in February 2014.

While steps were being taken to promote the adoption of outside directors, the Ministry of Economy, Trade and Industry set up the Corporate Governance System Study Group (hereinafter referred to as "the Study Group") in March 2012. The Study Group was created in an attempt to put in order the expected roles of non-executives, which is the prerequisite for using non-executives including outside directors, and to consider the entire corporate system.

## **2. Publishing Corporate Information in Light of this Guideline**

### **2.1 Target of this Guideline**

This guideline is targeted at the companies and directors and Audit & Supervisory Board Members (*Kansayaku*) of such that are listed on the financial instruments exchanges. Unlisted companies and the directors and Audit & Supervisory Board Members (*Kansayaku*) of such that are considering to aggressively examine their corporate governance system can refer to this guideline.

Under this guideline:

“Company” refers to company listed on a financial instruments exchange.

“Executive” refers to representative director or other executive director of companies with Audit & Supervisory Board (*Kansayaku-kai*) while it also means executive officer of Companies with Committees.

“Non-executive” refers to outside director<sup>3</sup> and Audit & Supervisory Board member.

“Officer” refers to director, Audit & Supervisory Board member, and executive officer.

“Audit member” refers to Audit & Supervisory Board member and Audit Committee member.

Under this guideline:

- (1) Matters targeted at listed companies are indicated by “companies” while
- (2) Matters targeted at directors and Audit & Supervisory Board Members (*Kansayaku*) are represented by, for instance, the “board,” “outside directors,” and “Audit & Supervisory Board Members (*Kansayaku*).”

According to the concept of the Study Group

- (1) Matters to be observed are indicated by use of the word “shall.”
- (2) Matters to be recommended are indicated by use of the word “should”
- (3) Matters to be considered as an option are indicated by use of the word “could”.

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<sup>3</sup> To fulfill the expected role from an outside perspective, an outside director is required not to execute or have executed operations of the company or any of its subsidiaries (Article 2, item (15) of the Companies Act).

## **2.2 Publishing Corporate Information**

The company could publish aggressively how its corporate governance system is<sup>4</sup> including how to make strategic use of non-executives, in light of matters stated on this guideline and the interim report of the Study Group (Comply AND Explain).

Then, given the above statement of 1.1 (P.1), the roles of non-executives and corporate systems relating to them differ, according to the roles of the board (for instance, a monitoring type specializing in supervising, an operation type with emphasis on decision on the execution of the operations, or a hybrid type of both). It is important for the company to examine such things consistently and publish them to outside. In this regard, it is important to refer to this guideline and interim report of the Study Group, taking into account these viewpoints.

## **3. Board of Directors**

### **3.1 Roles of the Board**

- 3.1.1 In accordance with the Companies Act, the board shall take executive decisions on material matters of the company's operation, and shall supervise execution of executives' duties.
- 3.1.2 With sufficient information and faithful and due care, the board shall make a decision so as to enhance corporate value.

### **3.2 Selection and Structure of the Board**

- 3.2.1 The company could care about diversity on selection of constituents of the board to enable management advice and supervision over management based on diverse value.

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<sup>4</sup> According to the Revised Companies Act, the company may select a company with audit committee as the new institution design. Factoring in selection of such a new institution, the company could consider and publish how its corporate governance is.

### **3.3 Operation of the Board**

- 3.3.1 The company should set the agenda of the board, so that the board may vibrantly discuss matters required for decision on the execution of important operation and supervising the execution of duties.
- 3.3.2 The company should deliver documents or explain about items brought onto the agenda of the board for discussion in advance enough to provide ample time for them, so that the board attendants may express opinions, make indications, or raise questions in a meaningful manner.
- 3.3.3 As the organizer of the board, the chairperson shall ensure a constructive relationship between executives and non-executives, and provide and promote an environment that allows open discussion.
- 3.3.4 To reinforce the supervising function of the board, the company could separate the chairperson and executives.

### **3.4 Dialogue with Shareholders**

- 3.4.1 The company should consider the way of the dialogue with shareholders to improve corporate value.

## **4. Executives**

### **4.1 Roles of Executives**

- 4.1.1. Executives shall execute the operation with sufficient information and faithful and due care enough to assume a central role for improving corporate value.

## **4.2 Selection of Executives**

4.2.1 The company should consider what the transparent process in election and appointment of executives is, taking into account the fact that nomination is an important means of executives' appraisal.

## **4.3 Compensation of Executives**

4.3.1 To evaluate performance objectively and take it into account appropriately for their compensation, the company should consider what the transparent process in determining executives' compensation is.

## **5. Non-Executives Including Outside Directors and *Kansayaku***

### **5.1 Roles of Non-Executives Including Outside Directors and *Kansayaku***

5.1.1 In concert with other non-executives including Audit & Supervisory Board Members (*Kansayaku*), non-executives shall prevent illegal or grossly improper execution of the operation. To that end, they shall look into facts suspicious of illegality, not only in relation to items brought onto the agenda of the board but also concerning information available to them, and express their opinions at the board on such matters.

5.1.2 To sustain continued enhancement of corporate value, making use of ones' insights and experience in and out of the company, outside directors should express their candid opinions from an outside perspective on material matters in the execution of operations, such as developing management strategies, making investments and M&A, and implementing management & structural reforms, coping with risks such as conflicts of interest that may inevitably occur.

5.1.3 Outside directors should express their candid opinions on decisions of election, appointment and compensation for officers, given that the decision of nomination and

compensation represents an important means of officers' appraisal.

- 5.1.4 Non-executives should communicate with executives concerning corporate management policies and matters brought onto the agenda of the board.
- 5.1.5 Non-executives shall execute the duties with a full understanding of their expected roles and secure ample time to dedicate themselves to the duties.

## **5.2 Selection of Non-Executives Including Outside Directors and *Kansayaku***

- 5.2.1 Prior to selecting non-executives, the company shall disclose the expected roles of non-executives to non-executives and shareholders.
- 5.2.2 The company should decide the criteria for selecting non-executives, where the criteria is whether or not they are capable of monitoring and advising in relation to the company's management strategies.
- 5.2.3 To ensure selecting independent non-executives, the company could decide the specific selection criteria for independence of non-executives in addition to the legal requirements.
- 5.2.4 The company could call upon non-executives to select candidates of other non-executives, instead of asking executives to recommend some, to ensure high degree of independence from executives.
- 5.2.5 The company should consider the longest tenure of non-executives, weighing the balance between effectiveness of supervision and independence. To maintain independence of non-executives, the company could establish the longest tenure of non-executives.

### **5.3 Compensation of Non-Executives Including Outside Directors and *Kansayaku***

5.3.1 The company should correlate the level of non-executives' compensation with time that they spend on their duties and roles as non-executives.

### **5.4 Roles of Audit Members**

5.4.1 As non-executives vested with investigation power over the operation of the company, audit members shall investigate whether illegal or grossly improper operation is executed, audit the conditions of executives' execution of operations including the way internal control system is put in place, and also audit effectiveness of accounting audit including independence of the accounting auditors.

5.4.2 Audit members shall gather information necessary for them to execute their duties by communicating with directors and accounting auditors, and cooperating with internal audit and internal control units. Outside Audit & Supervisory Board Members (*Kansayaku*) could gain primary information by themselves if necessary.

5.4.3 Once a misconduct actually happened in the company, audit members should thoroughly look into the root cause of wrongdoing, and, if necessary, should organize an investigation committee in coordination with outside experts, who have no vested interest in the company.

5.4.4 Audit & Supervisory Board Members (*Kansayaku*) could express their opinions on the operation of the company in terms not only of legality but also of appropriateness at the board or other important meetings they attend.

## **6. Support system for Non-Executives Including Outside Directors and *Kansayaku***

### **6.1 Sharing Information**

- 6.1.1 At an opportune timing for non-executives, such as the time when they are elected, the company should provide them with information and knowledge on business activities necessary for them to supervise management.
- 6.1.2 The company should build systems of sufficiently sharing internal information with non-executives. The company should deliver documents or explain about items brought onto the agenda of the board for discussion in advance enough to provide ample time for them, so that non-executives may express opinions, make indications, or raise questions in a meaningful manner.
- 6.1.3 The company shall reinforce cooperation between audit members and internal audit and internal control units so as to provide more effective audit.
- 6.1.4 The company should build a dual reporting structure, by which, the same information on internal audit and internal control as is reported to the management is also reported to non-executives at the same time.
- 6.1.5 To find a clue of wrongdoing, the company could list audit members as the recipients of information from whistle-blowers.

## **6.2 Support Staff**

- 6.2.1 The company should secure support staff for non-executives to help non-executives fulfill their roles.

## **6.3 Bearing the Expenses**

- 6.3.1 The company shall bear the expenses incurred by non-executives for fulfilling their roles (including the expenses to outsource or delegate such roles to an external expert independent from the company).

## **6.4 Build an Environment for Cooperation**

6.4.1 To help non-executives supervise management effectively, the company should provide environment for directors and Audit & Supervisory Board Members (*Kansayaku*) to actively share information and compare notes among them, including regular meetings between executives and non-executives.

## Appendix: Roster of the Corporate Governance System Study Group

As of June 30, 2014

Chairman	Hideki Kanda	Professor of Graduate Schools for Law and Politics/Faculty of Law, The University of Tokyo
	Yasuhisa Abe	Managing Director, Keidanren
	Nobuyuki Isagawa	Professor of Graduate School of Business Administration Division of Business Administration, Kobe University
	Takeyuki Ishida	Executive Director at Institutional Shareholder Services
	Akitsugu Era	Vice President, Head of Corporate Governance, BlackRock Japan Co. Ltd.
	Kenichi Osugi	Professor of Law School, Chuo University
	Junji Ota	Chairperson, Japan Audit & Supervisory Board Members Association
	Akiyoshi Oba	President & CEO, Tokio Marine Asset Management, Chairman, The securities Analysts Association of Japan
	Yasuhiro Osaki	Professor of Law, Waseda University
	Hiroyuki Kansaku	Professor of Graduate Schools for Law and Politics/Faculty of Law, The University of Tokyo
	Keizo Kuromi	General Manager, Corporate Legal & General Affairs Dept., Sumitomo Corporation
	Soichiro Sakuma	Representative Director and Executive Vice President, Nippon Steel & Sumitomo Metal
	Minoru Sawaguchi	Partner, Mori Hamada & Matsumoto
	Masaki Shizuka	Director & Senior Executive Officer, Tokyo Stock Exchange, Inc.
	Seiya Simaoka	Director, Member of the Audit Committee, Toshiba Corporation
	Takaya Seki	Managing Director, Corporate Practice Partners, Inc.
	Kazuhiro Takei	Partners, Attorney at Law, Nishimura & Asahi
	Yuichi Tashiro	General Manager, Transaction Legal Affair Div, Corporate Legal Center, CANON INC.
	Shirou Terashita	President and CEO, IR Japan, Inc.
	Yoshinori Nishimura	Audit & Supervisory Board Member, Shiseido Co., Ltd.
Daisuke Hamaguchi	Chief Investment Officer, Pension Fund Association	
Tomotaka Fujita	Professor of Graduate Schools for Law and Politics/Faculty of Law, The University of Tokyo	
Noriyuki Yanagawa	Professor of Graduate School of Economics, The University of Tokyo	
Observer	Saburo Sakamoto	Counsellor, Civil Affairs Bureau, Ministry of Justice
	Motoyuki Yufu	Director, Corporate Accounting and Disclosure Division, Financial Services Agency