

Minutes of the 2nd Council of Experts
Concerning the Corporate Governance Code

1. Time and date: 4:00–6:00 pm, September 4 (Thursday), 2014
2. Place: Financial Services Agency

[Yufu] We are informed that Mr. Kanda may be late today. It seems all other members are already present.

I'd like to ask camera crews to take pictures only during the opening part. Once the presentation starts, please refrain from shooting. Thank you in advance for your understanding.

[Ikeo, chairman] I would like to open the second Council of Exports Concerning the Corporate Governance Code. I really appreciate your taking the time from your busy schedules for the Council.

As approved by the members in the previous Council, this Council is basically open to public. This time we have more seats for the audience. I appreciate your understanding.

Now I would like to start the proceedings. Roughly speaking, we have two agenda items to cover today. The first one is an explanation of the OECD Principles for Corporate Governance by Advisor of this Council, Mr. Mats Isaksson from the OECD. Please note that Mr. Isaksson will make a presentation in English with consecutive interpretation. After the presentation by Mr. Isaksson in accordance with Material 1, we will have a Q&A session and discussion. This is the first half of today's Council. It will take approx. one hour.

The second agenda item for the remaining half of the Council is about what should be written in the preamble as the basics of the Corporate Governance Code. After the Secretariat explains the scope of the discussion, I would like the members to discuss such considerations.

We will cover these two agenda items today. Now I would like to hand it over to Mr. Mats Isaksson from the OECD. Please note that the presentation time should be forty minutes including translation time. Mr. Isaksson, please go ahead.

[Isaksson, advisor] Thank you very much, Mr. Chairman, Ladies and Gentlemen, Council Members and participants in this meeting. First of all, good afternoon and thank you very

much for the invitation and for the opportunity to talk to this distinguished group of experts. I will talk about the role and the work of the OECD, as a global standard setter. And I will discuss how the OECD's work and our approach to corporate governance can be relevant to the work of this Council and to the development of the Corporate Governance Code in Japan.

The very first point I would like to make is that the OECD is a “do” tank, not just a “think tank”. Corporate governance, from our perspective, is a means to an end. It is not an end in itself. So, the best place to start is probably to discuss what we want to achieve with corporate governance policy and what we want to achieve with OECD Principles of Corporate Governance. This is stated on the second slide that you have in front of you, which summarizes the mission of the OECD Corporate Governance Committee as “contributing to economic efficiency, sustainable growth and financial stability.” If you look at the third slide, we can narrow this objective down a little bit more and define it as solving following two challenges: “to ensure that household savings can be used for corporate investments” and “to stimulate capital formation”. Capital formation, as you all know, is by far the most important factor behind any economic growth.

I want us all to reflect on what we want to achieve with our reforms in corporate governance and how we think we can help our economies obtaining sustainable growth, value creation and capital formation. If we don't understand what we want to achieve we will never understand what kind of rules we should have in terms of corporate governance.

In the fourth slide, I have illustrated OECD's perspective with the three different steps of the investment chain. Our perspective is that corporate governance plays the role, and the quality of corporate governance rules plays a role at every step in the process of capital formation and investment. For us, the objective of corporate governance policy is to create the best possible conditions for corporations to access capital; for capital markets to allocate capital to the best possible use, and; for markets and managers to manage the use of this capital for productivity and growth in individual companies. This is the political objective and economic reality behind the OECD Principles.

In terms of the history of the Principles, I have put down in slide number 5, a few dates and a few steps. Just to recap very quickly, the OECD Principles were first issued in 1999, and revised in 2004. I should also mention that the OECD Principles is one of the core standards of the Financial Stability Board in Basel, which means that it is a de facto G20 standard, because of the membership of the Financial Stability Board covers also G20 countries.

Now, what is the purpose of the Principles? Who should use them? And how should they

use them? I'll try to explain this in picture number 6. The first constituency that we reach out to is obviously governments and regulators who meet in Paris several times every year to discuss the Principles and the implementation of the Principles. And the purpose of these exchanges is to provide regulators and governments around the world with the tools to improve their own regulatory framework by learning from each other. The Principles also provide guidance to stock exchanges, to other market actors, to professional bodies, and also to some extent, to individual investors and institutions in the market place.

In terms of the character of the document, the Principles are, "outcome oriented". It means that they define certain objectives that are desirable in order to promote sustainable growth, value creation and investment. And they also identify possible ways to achieve these outcomes. This means that the Principles leave room for individual countries to adapt the implementation of the Principles to their own economic, legal and historical context.

When we applied this approach, some people say this is a weak approach, because we don't say exactly and in detail what everybody should do or how regulations should be formulated. I have the absolutely opposite view. I believe our approach is a very strong approach, because what we are saying is that everybody can implement the Principles, regardless of your legal, economic or historical context. It can be done. These objectives can be met. These outcomes can be reached in any jurisdiction. There are no excuses. And it's up to the regulators, the legislators and the business community in each country to find the tools for doing it. So, in a sense, it's a very strong concept, because there's no escape. There is no way of saying that this cannot be done.

We have seen very encouraging, very innovative and very successful ways by individual countries to live up to the OECD Principles of Corporate Governance. And there is a plethora of experiences around the world that we discuss at the OECD, and that we can share with you and that we think is a great help to all our members and partners around the world.

So far, I have discussed the purpose of the Principles: the economic growth, the investment and the value creation. I have talked a little bit about the history of the OECD Principles. And I have discussed how they can be used. So I think it's time to turn to slide 7 where I will discuss different elements of the Principles. In picture 7 and picture 8, you will see that the Principles address six main areas, and I will go through them one by one briefly to give you a hint of what they contain in more detail. If you find my presentation interesting, I think the Principles are also in your package, so you can study them in more detail after this meeting. There are also a lot of materials on the OECD website that you can download and read about the Principles.

The first thing we note is that the Principles address six main areas in six different chapters. So, they are not only about, for example, the board of directors. That is one part of the Principles. But the document covers a lot of policy areas.

The very first chapter of the Principles is about the quality of the legal and regulatory framework. That includes all the rules and regulations that influence corporate governance one way or another. We needed to invent this new concept “legal and regulatory framework of corporate governance” as a catchword for all the different legal and regulatory domains that influence corporate governance, that influence board behavior, that influence shareholder behavior and that influence the relationship between creditors and companies, between creditors and shareholders and between shareholders. Just to give you a few examples of all the components of this framework. These are company law, securities regulation and bankruptcy law. There are also private contracts between market participants. There are listing requirements and there are corporate governance codes. So you see there is a multitude of different regulatory and legal and quasi-legal instruments, that influence the ultimate quality of corporate governance. So, one of the main messages in the first section is to make the system consistent. We don’t want contradictions between the different layers and segments of rules and regulations. Companies and investors need consistency. The second message in the first chapter is to make sure that you have your objectives right, that policy makers understand what they want to achieve with the legal and regulatory framework. And the one objective that is mentioned in the OECD Principles is to promote market efficiency, to make sure that we get sustainable growth, value creation and investment.

The second part is about shareholder rights and key ownership functions. It’s pretty straightforward and describes the main features of what shareholders can and should do. I would say there is one element that would resonate well with the Japanese Stewardship Code. The chapter promotes the exercise of ownership rights by institutional investors. And that part actually came into the Principles in 2004 after the scandals when a lot of institutional investors were considered to be very passive, both in Europe and United States.

The third chapter is about the equitable treatment of shareholders, which is about the classical conflicts that may accrue within the corporation and among shareholders. It is about different classes of shares, for example, preference shares, ordinary shares, and shares with different voting rights. It may be interesting to note that the OECD Principles does not advocate one-share-one-vote. It is about the equitable treatment between domestic and foreign shareholders. It’s about the conflict between insider shareholders and outsider shareholders. So, the classical and potential conflicts between shareholders are covered in chapter 3.

On page 8, you'll find that there is one chapter on the role of stakeholders and there is one chapter on disclosure and transparency. I will not go into any detail.

The last chapter in the OECD Principles is concerned with the responsibilities of the board of directors, and I'll spend just a few minutes on that, primarily because I think it's a good example of what I called is "outcome oriented approach" to the OECD Principles. It can be used as an illustration how the Principles are used and how they function.

The chapter lists a number of issues that the board should do. This includes issues like fair treatment of all shareholders, monitoring of management and ensuring the integrity of corporation. These are all examples of things that a good board should do in order for a company to function well. There are other things as well. These are just three examples. So, fairness, integrity and monitoring are the objectives. To go back to our earlier terminology, it's the desired outcome. And in order to reach this outcome, the Principles conclude that these tasks require that the board has "objective and independent judgment". This in turn requires that the company considers introduction of non-executive directors on the board. So again, I hope you see the logic in our thinking that the Principles are not an end in itself. There is an objective and outcome that we want to achieve. We want to meet these objectives – we want to solve a problem – by arrangements that we believe makes sense and that experience and research suggest work. If we don't have any problem and any analysis, we will never find the right rules. And in the example I just mentioned, the Principles conclude that the desired outcome is best achieved by a board that has objective and independent judgment.

The OECD Principles are currently under review. And this work will be concluded sometime next year. So, it is too early to go into any detail about what changes may occur in the next version of the Principles. But this is no problem for this Council. Because all the core values in the Principles will remain. The OECD countries have already agreed that the current version of the Principles is the floor. And the core values that they represent and which are well-known, will be preserved in the new version.

I have one minute left, I think, as I started one minute late. So I'll be very quick to the last two slides, because there are at least three papers on our website at the OECD, which discuss these two slides in some detail. The slide represents a rough list of important issues that we believe influence or may influence the way that the corporate governance system works, and the investment chain in future capital markets. These changes in our market economy take place all the time. There is nothing new. This is also why the OECD Principles, like I think most codes are and should be, are living documents.

In a rapidly changing world, it is more important than ever that we keep our eyes on the ball. That we make sure to design our rules in corporate governance in a way that is guided by our ambitions to increase corporate performance, to improve value creation in the business sector and to promote sustainable growth. And I'm very happy that this is also one of the objectives of this Council.

Thank you very much for your time, and I'm happy to take any questions.

[Ikeo, chairman] Thank you very much.

Now we are moving on to Q&A and discussion. If you have any questions or opinions you'd like to share regarding the presentation by Mr. Isaksson, please do not hesitate to voice them.

All right, Mr. Toyama will speak first, and then Mr. Horie.

[Toyama, member] Thank you very much for your explanation. In Japan, corporate governance is still often viewed as a tool exclusively for optimizing shareholders' short-term profits, or understood almost as a same meaning as "compliance" as a measure to prevent scandals. After hearing today's presentation, I would like to ask and confirm that this issue [corporate governance] is all about enhancing performance of the overall economy, and aiming at longer term sustainable growth instead of short-term growth. That is corporate governance, and the whole idea of enhancing corporate governance activities. I would like to confirm whether my understanding is correct or not. Also, I would like to ask another question. You mentioned that the OECD Principles take a strong approach and are *de facto* [standards as well]. Conversely, the OECD Principles, in some ways, serve as minimum *de facto* standards in each country or region, or market, and each country should have higher standards: the assumption being that each country should aim at higher standards, considering its historical background and circumstances. It sounded like that to me. Could you please clarify this point?

[Isaksson, advisor] Thank you very much. In terms of the link to economic performance, I think there are two components that are required. First, refer to my slide number 4. Good corporate governance creates the best possible conditions for the flow of savings between household savings and corporate investment to work well at all three stages. First, households will be willing to put their money into productive use. They will not keep it in the mattress, since they know that there is some shareholder protection. In the second step, they are willing

and able to allocate this money to those companies that can make the best possible use of the money. And in the third stage, good corporate governance makes those people who take care of the money inside the company be accountable for managing other people's money well. I think this is decent. So, it improves the efficiency of capital markets, and it also improves the performance of the real economy, the working of a factory if you want. This factory is very often forgotten in corporate governance discussion.

My answer to the second question is much shorter. I agree that the OECD principles are high level. But I think they are more demanding than any national code. I think it is partly a matter of terminology or semantics. I think the difference is that the national code is always more detailed. But there is no difference in terms of ambition.

[Horie, member] Thank you very much for the very clear explanation. I would like to have just one question. I discussed very similar, analogical discussion with regard to the pension fund governance, with your colleague, Mr. Grant Kirkpatrick, a senior economist, many years ago. And OECD already set up a principle for pension fund governance. Which part we are behind in this kind of principles? In this principle, already you discussed similar issues with other Japanese related people. In which principle the Japanese current status is far behind from the principles? Would you please give us your personal comment?

[Isaksson, advisor] I think the question was in what area is Japan behind the OECD principles. I think we should have that discussion when the code is ready. But, already now, I think there are a few observations we can make. There are concerns in Japan about the productivity in the corporate sectors. There are concerns about the competitiveness of Japanese industry. There are concerns about the return on equity. And there are some concerns about holding of cash in certain industries. These are the general concerns that the Japanese economists and analysts are raising and also taken up in the framework of the Abenomics reform program. As I always do, I would like to start with the economic problems. I think these are, perhaps, the issues that we should think about first. And then, rather than just comparing with the OECD Principles, we should think about real economic challenges that we need to address. After all, Principles are a synthetic document. We need to start with the reality, and ask ourselves what the challenges are and how we can contribute to help Japanese economy, to solve the problem in productivity or competitiveness, cash holdings or other things. Once we have identified these problems, the OECD Principles and other OECD work on corporate governance is a great and very useful source of information and advice.

[Ikeo, chairman] Time is running out. Unless you have any must-ask questions, I would like to close the Q&A session.

In this regard, however, I think it's better to reconfirm that we have correct understanding of the relationship between the OECD Principles and each country's CG code. In the presentation, I think the OECD Principles are described as the floor, which does not allow any deviation by referring to special circumstances of each country as an excuse. In that sense, it is a strong approach. The OECD Principles are comprehensive in that way. On the other hand, each country's code can stipulate more specific details, and incorporate specific circumstances of each country. Mr. Kanda, what do you think? I would like to have your confirmation.

[Kanda, member] Yes, what you said is correct.

[Ikeo, chairman] Any other comments?

Thank you very much, Mr. Isaksson. [Applause]

Now we are moving to another item on today's agenda. I would like to ask the Secretariat to explain the basics of the Corporate Governance Code, and then start discussion. Please go ahead.

[Yufu] I will try to make the explanation from the Secretariat as short as possible. We prepared Materials 2, 3 and 4. I will briefly explain these materials. First, I will cover Material 2, a two-page paper in a horizontal layout. As a basis for today's discussion, we compiled this material, which outlines what is written in the preamble, foreword, or the like of the OECD Principles, codes of other countries, and Japan's Stewardship Code.

Let me make a correction first. At the last Council, I told that AFEP/MEDEF Code is the only code designated by the French Commercial Code. However, France has another Code - the MiddleNext Code for small and mid caps. Therefore, today we distributed Material 5-1, which is a Japanese translation of the MiddleNext Code. MiddleNext is an association which represents small and medium-sized listed companies in France.

Please take a look at page 1. The corporate governance code of each country describes the background of establishing the code, followed by objectives and explanation of corporate governance. The German and French Codes also explain the institutional designs of stock corporations in the respective countries.

Please turn to the second page. First, it describes that the code is 'Principles-based,' and then explains 'Comply or Explain.' On the right side, there is a column for Japan's

Stewardship Code. The Stewardship Code explains the whole idea of ‘Principles-based’ approach and ‘Comply or Explain,’ because they are rather unfamiliar concepts in Japan.

Furthermore, in this row, you can see that the German Code includes some – not many – suggestions as a separate category, to which ‘Comply or Explain’ does not apply immediately.

The next row is about the evaluation of ‘Explain.’ The UK code and Japan’s Stewardship Code state that one should not automatically give a negative evaluation to a corporation which explains instead of complying.

Then it shows the applicable scope of each corporate governance code. In case of the UK, the Code applies to companies with a Premium listing on the UK main market. Even within the Premium listing category, the provisions are slightly different for large FTSE 350 companies and smaller ones. Germany and France have EU regulated markets under the unified EU regulatory framework. Their codes apply to companies listed on such regulated markets. Furthermore, in case of France, as I said in the beginning, companies with a market capitalization of less than 1 billion euros may apply the MiddleNext Code instead of the AFEP/MEDEF Code, which we explained in the last Council and distributed the material.

As for the possible revision of the codes in the future, as a typical case, the German Code is scheduled to be revised every year, while Japan’s Stewardship Code is scheduled to be revised basically in every 3 years. It is written that the UK Code and the OECD Principles are subject to regular or incremental review. In the last row titled “Other,” some codes explain the structure of the part of particulars or particular provisions following the preamble or foreword.

This is the situation of other countries’ codes and the OECD Principles. Next, please take a look at Material 3 – a one-page vertical paper. This material lists up the items I just mentioned according to the chart, with the numbering from 1 to 8, as a guide for the discussion.

We also prepared Material 4, which roughly corresponds to the said items. Material 4 shows excerpts from the actual text of each code, corresponding to the said item numbers from 2 to 8 of Material 3. For example, please look at the first page titled Explanation of Corporate Governance. This section features excerpts from the OECD Principles and codes of other countries covering 4 pages. If we discuss from scratch what corporate governance is all about, we may well have to have too many meetings. However, for today’s Council, I would like you to look at the statement approved by the Cabinet on June 24, which is the basis of this Council of Experts. I mean a paragraph in the first column, reading “...the system which

supports companies making timely entrepreneurial decisions” and so on. As we have such a framework, please express your opinions by using it as a reference. Following that column, there is an explanation of how the OECD Principles describe corporate governance.

Please take a look at page 2, which shows excerpts from the OECD Principles of Corporate Governance. In the bottom paragraph, it is underlined that improved corporate governance will “help improve the confidence of domestic investors” and so on. Unfortunately, the sentences before that were omitted. I think the omitted part is related to the question raised by Mr. Toyama earlier. You can see the omitted part on page 12 of the Japanese version [of the OECD Principles], so I would like to encourage you to take a look at it later. In this part of the OECD Principles, it is written that if corporations are to attract long-term “patient” capital, corporate governance must be improved.

Then, please take a brief look at the structure of Material 4. Pages 3 and 4 provide explanations of corporate governance. You can see the page number at the right bottom of each page. Page 5 offers an explanation of the institutional designs of stock corporations in Germany and France.

Two pages from page 7 show excerpts regarding explanations of ‘Principles-based.’

Five pages from page 9 show excerpts regarding explanations of ‘Comply or Explain.’

Page 14 is about an evaluation in case a company chooses to explain instead of to comply.

From page 15, concerning applicable scope or applicable companies of the Codes, excerpts from each Code are compiled.

Let me briefly explain only page 16. The upper half of page 16 is an excerpt from the German Code. When you just read this German Code, it is not clearly specified that the Code is applicable only to companies listed on EU-Regulated markets. However, as mentioned in the note, in relation with the definition of the Stock Corporation Act, etc., the German Code is applied to companies listed on EU-Regulated markets.

Remaining pages are allocated to the applicable scope of the Code. Finally, it shows excerpts about review of the Codes in the future.

That’s all for my explanation.

[Ikeo, chairman] Thank you very much.

Now, I would like to open a discussion related to the presentation just made. Before that, I would like to refer to a paper submitted by Member Mori from the Japanese Institute of Certified Public Accountants. He is absent today. You have his opinion in writing – it is a piece of paper, which is unnumbered. It is related to section 3 of the explanation just given. In connection with the explanation of stock corporation systems in other countries, Japan has such systems as Company with Corporate Auditors (*kansayaku*). Thus, in his opinion paper, he asserts that we should clearly explain such systems. Please refer to his paper.

Well, regarding the explanation just made, using Material 3, we would like to have a discussion on basic matters concerning the Corporate Governance Code. In fact, when we write a paper, a preamble is actually written last upon completion of all the body of the paper, and in accordance with the body. Yet as mentioned earlier, the preface includes the scope of discussion – what we cover in our discussion – in a certain sense. By writing such things in the preamble, we can roughly show the coverage or scope of our discussion. Given that, is it preferable, or appropriate to limit the scope of the discussion in this way? I would appreciate it if you expressed your opinions including such a point. What do you think? Okay, Mr. Oguchi, please go ahead.

[Oguchi, member] Thank you. This may partly overlap with what I said at the last Council. Concerning the “Explanation of Corporate Governance” in Material 3, various concepts in other countries and the OECD Principles are introduced in Material 4. As I said in the first Council, I’d like the Council to focus on the concept of the Board of Directors in the Japan’s Stewardship Code, as shown on page 4.

There are two reasons. One is persuasion to win the understanding. At the time of developing the Stewardship Code, this concept was, of course, discussed by the relevant Council of Experts, and they requested public comments on it. In that way, it was agreed upon by winning the understanding. Let me refer to the message as well. With regard to the roles of the Board of Directors – it is also related to the earlier presentation by Mr. Isaksson - first there should be a clear message that the Board of Directors “has the responsibility to enhance the corporate value.” I assume this is considered to be an “end” as in “means to an end” in the presentation by Mr. Isaksson; and as “means” for such a purpose, the Board of Directors exerts “proper oversight on the management.” I think this is related to the monitoring in the OECD’s presentation. As for “exerting adequate governance,” it is considered to include various aspects, such as consideration of stakeholders as mentioned earlier, and how to maintain transparency and fairness. Or a diversity issue, which may not have been pointed out

earlier, but much discussed recently. It is a broad concept including but not limited to these points. The statement is concise and short, thus may be too abstract, but I believe it is very persuasive for the purpose of deeper discussions in the future. This is the first reason.

The second reason is the consistency. As written in Material 2 as well as on page 4 of Material 4, the stewardship of institutional investors and corporate governance are complementary like two wheels of a cart. The Stewardship Code describes functions and roles of the Board of Directors. Because these two Codes are complementary like two wheels of a cart, both Codes need to aim at the same direction. Otherwise, the cart will not move forward. So I think that in the Corporate Governance Code, we should write what is written in the Stewardship Code, although it is a repetition. By doing so, we could send a consistent message externally. Therefore, I think this concept has a very important meaning. That's all.

[Ikeo, chairman] Thank you very much.

Over to you.

[Uchida, member] I'd like to raise a point on Section 3 - Explanation of Stock Corporation System. There may be some overlaps with Mr. Mori's opinion, but I think we should write basically how Japanese systems work, in a clear and understandable manner. The Companies Act was revised this June in a way to introduce "Company with Audit and Supervisory Committee" in addition to the existing two types, namely "Company with the Board of Corporate Auditors (*kansayaku*)" and "Company with Three Committees." We now have 3 different institutional designs, allowing each corporation to choose one at its own discretion. In that sense, this is a highly flexible system. By contrast, the system may be difficult to understand from outside Japan. I think we should provide an easy-to-understand explanation including that these 3 types are legislatively equivalent. Furthermore, we need to explain *Kansayaku* System (Audit & Supervisory Board) itself in a careful and easy-to-understand manner. When I meet with foreign investors, they often point out that Japan's *Kansayaku* System (Audit & Supervisory Board) is very difficult to understand. In fact, it seems that many investors do not fully understand the system, I'm afraid. Our company is a "Company with the Board of Corporate Auditors (*kansayaku*)" and we have been trying to provide a plain explanation on the system in our IR effort. Yet I hope the Code, in both Japanese and English versions, will provide an understandable explanation in this regard.

However, I believe that the Code should well explain not only legislative obligations and rights, but also expected roles of *kansayaku* (Audit & Supervisory Board Member). Although I may not be the right person to talk about it when Mr. Ota is seated next to me, we should

clearly describe expected roles of *kansayaku* (Audit & Supervisory Board Member). Specifically, *kansayaku* (Audit & Supervisory Board Member) do not merely assume the functions of Compliance Officer. For example, they hold regular meetings with company executives including Chairperson, President and CEO, regularly participate in significant meetings such as the Board of Directors meetings, and conduct on-site inspections at offices, factories and affiliated companies. Through these activities, they are in a position to obtain considerable firsthand information on the site. Therefore, I think they are expected to provide opinions and advices on management strategies or business strategies as well, taking advantage from such activities. With this regard, I would like to see that the Code describes such essential expected roles, taking this opportunity. It would encourage corporations to take better initiatives, not only helping investors deepen their understanding. This is my request.

If we find that the preamble becomes too complicated with the descriptions of such expected roles of *kansayaku*, for example, we could add one chapter for *Kansayaku* System (Audit & Supervisory Board). Or we could describe such things in Chapter 6: The Responsibilities of the Board, like the OECD Principles, as a part of Japanese systems. I really hope the Code includes clear descriptions of expected roles.

[Ikeo, chairman] Next one, please.

[Horie, member] I'd like to discuss the Applicable Scope of the Codes in section 7 of Material 3. As explained by Mr. Yufu earlier, I got an impression that the majority of other countries do not apply their code to all listed companies, but rather limit the applicable scope based on market capitalization or so on. From my standpoint as an institutional investor, when the objectives of the Code is to increase medium-to long-term corporate value in the entire market – I'm so sorry if it may sound rude – even if smaller caps tried hard, if large caps do not cope well, we cannot expect a high return. This is a very practical aspect. I think it would be great if corporate value of all listed companies increased without exception, but there are diverse companies. If we establish the code uniformly applicable to all companies, even if it adopts 'Comply or Explain' approach, there will be cases where it is impossible to coordinate among a large number of stakeholders. Thus, from a practical standpoint of an institutional investor, I would appreciate it if we could find an appropriate scope, by focusing on companies with a certain level of market capitalization – not limiting too narrowly – incorporating decent practice in a way to make a positive impact on the return from the stock market. That will be highly appreciated from the perspective of institutional investors.

[Ikeo, chairman] Thank you very much.

Does anyone have any input related to this point? I turn it over to you.

[Callon, member] I believe what Mr. Uchida pointed out regarding *kansayaku* (Audit & Supervisory Board Members) is very true. When I speak with global investors, I'm often asked the same question: given that *kansayaku* do not have voting rights at the Board of Directors meetings, can they truly fulfill their supervisory functions with regard to significant corporate decisions such as company's medium-term business plans? I have the impression that *kansayaku* are currently not fully used to their fullest to support companies' successful operations, and feel bad about that. I certainly agree with the introduction of more external directors, but even under the current *Kansayaku* System, I'd like to encourage *kansayaku* to actively participate in board discussions not only from a narrow perspective focusing on legal compliance, but also from a broad perspective of increasing corporate value, and have been thinking we might want to express such support through the Code. In sum, we should encourage the full use of the current *Kansayaku* System – I totally agree with Mr. Uchida.

[Ikeo, chairman] To sum it up, a *kansayaku* (Audit & Supervisory Board Member) is not a member of the Board of Directors, and does not have the same authority as a director. Nonetheless, in reality, *kansayaku* (Audit & Supervisory Board Member) attend the Board of Directors in many companies.

[Callon, member] Of course, the majority attend. They are required to attend. However, at the moment, I think the role of *kansayaku* is narrowly defined, placing disproportionate weight on compliance. I believe there is an option to expand the role of *kansayaku* so that they can interact more with shareholders and the management, and become directly engaged in increasing the corporate value. That's why I spoke up.

[Ikeo, chairman] Thank you very much.

Please go ahead.

[Ota, member] Mr. Uchida and Mr. Callon just shared opinions concerning the *Kansayaku* System (Audit & Supervisory Board), based on deep understanding. Putting it simply, I think foreign institutional investors are sort of solely asking whether *kansayaku* (Audit & Supervisory Board Member) in Japan have voting rights or not. I've been thinking that this kind of argument or assessment is meaningless. Of course, I understand suggestions from these two members. Yet those investors should not consider the only thing that matters is voting rights. Rather we should tell them what kind of functions *kansayaku* (Audit & Supervisory Board Member) perform in a corporation. In each company, *kansayaku* (Audit &

Supervisory Board Member) of course fulfill their obligations to attend the Board of Directors and to express their opinions. Otherwise, it will be a breach of their duties. However, specific methods of fulfilling their functions vary from company to company. This is not something unique about Japan; it is the same in other countries.

With regard to all agenda items to be discussed by the Board of Directors, *kansayaku* (Audit & Supervisory Board Member) 's conduct prior hearings for every item, and request corrections, if they find any problematic descriptions, etc. Every *kansayaku* (Audit & Supervisory Board Member) fulfills such duties. The reality is that companies patiently explain details of such tasks to foreign institutional investors. Some companies do so through their IR activities, etc. Nonetheless, I have to repeat that the question about the presence or absence of voting rights as well as the negative evaluation due to the absence are irrelevant here. If we follow such logic, the current Companies Act must be revised: I have to say that's a different argument. Yet, if the only real problem with Japanese corporations is voting rights of *kansayaku* (Audit & Supervisory Board Member), corporations can simply move toward being Companies with Audit Committee, etc. in accordance with the recent revision of the Companies Act. I think we should wait and see whether it will create appropriate competition among systems, which respond to the situation of corporate governance in each company.

Finally, when we write about it in the preamble or other section, we should take into account that 98% of companies listed on TSE have adopted *Kansayaku* System (Audit & Supervisory Board). Given that, we should aim at outcome-oriented structure of code-making. That is my strong desire.

[Ikeo, chairman] Thank you very much.

Does anyone have comments related to the point just made? Mr. Takei, please go ahead.

[Takei, member] I would like to raise two points. Let me talk about *kansayaku* (Audit & Supervisory Board Member) first. In the Japanese language version of the OECD Principles of Corporate Governance, the title of Chapter 6 is translated as "*torishimariyaku-kai no sekinin*," meaning "the responsibilities of the board of directors." However, the original text in English uses the wording "the Board." The Board is not limited to the board of directors as in the Japanese system. The Board does include the Board of Corporate Auditors (*kansayaku*) as well. What the OECD Principles require is to clarify where the Board exists and how it works, and to Comply or Explain accordingly. In such a context, our challenge is how comprehensively we can explain *kansayaku* (Audit & Supervisory Board Member). The point here is not only how to explain them in the Code. Japanese corporations also need to explain

these functions as the Board in an easy-to-understand manner. The important thing is how well the Board of Corporate Auditors (*kansayaku*) is functioning in the Board, in my opinion.

My second point is about the definition of corporate governance. This could result in an endless argument, which I would like to avoid today. Basically, I would like to mention two things based on the materials prepared by the Secretariat. First, the definition should be accepted by the Japanese society. Second, in connection with that, I think the definition in the Revitalization Strategy is very well made. It is easy to understand. The good point is that it uses the key phrase “continuously improving corporate value” in the definition. As mentioned by Mr. Toyama earlier, corporate governance is not for maximizing short-term profits for shareholders. Rather, it is a mechanism to contribute to the society, and the common ground is, after all, to continuously enhance corporate value, I think. The shortest possible definition of corporate governance would be the mechanism for continuously enhancing corporate value. It is the common ground for all concerned parties. We may expand the definition further, but we should not force ourselves to pursue too detailed a definition. Instead, it would be better to pursue a broader definition of corporate governance. To obtain consensus, even the definition in the Revitalization Strategy might be too detailed. Anyway, we should have the definition that suits the purposes of introducing the Code to be drafted in response to the Revitalization Strategy, which aims at supporting the growth of the Japanese economy through continuously enhancing corporate value.

The task for introducing the Corporate Governance Code is, as I understand, an “All-Japan” initiative, participated by all stakeholders including capital markets, creditors, and corporations. I consider “continuously enhancing corporate value” is a very good phrase as the common ground, and I hope the definition of corporate governance is based on continuously enhancing corporate value. I wanted to share these two points. Thank you.

[Oguchi, member] I’d like to raise two points. The first one is about *Kansayaku* System (Audit & Supervisory Board). Japan will have three different institutional designs hereafter. As discussed earlier, when these three types are equally valued, what we should write about is not explanation of each type. There is an overall concept covering all three types, and under such a common concept, companies are free to choose which institutional design they prefer. That is my understanding of the system. Therefore, instead of focusing on relative merits or functional details of each type, first we should clarify the overall concept covering three types, and then how to respond is a matter of accountability of each corporation, as far as I understand.

Second, regarding the applicable scope, which Mr. Horie discussed earlier, I was inspired

by Mr. Isaksson. He explained Access to Capital and Allocation of Capital in the investment chain. As for Allocation of Capital, it is institutional investors who allocate capital. So you could say we can just focus on potential investment destinations. On the other hand, if companies which need Access to Capital are not large enough to be investment destinations for institutional investors, I think we should consider an option to create the concept to cover such companies. So we need to strike a balance. We may be able to have a healthy discussion, if we discuss on which side we place emphasis upon striking a balance.

[Ikeo, chairman] Mr. Uchida, please.

[Uchida, member] In connection with what Mr. Takei just mentioned, I'd like to share my opinion about how to organize the Code. According to the Japan Revitalization Strategy revised 2014, the purpose of Corporate Governance Code is "promoting autonomous adaptations for sustainable growth of corporate values." Actually, most companies aim at a continuous increase in corporate value, and autonomous adaptations for that are responsibilities of companies. They are expected to do so. Therefore, I'd like to avoid making the Code be heteronomous – forcing certain specific forms on companies. I'd like to make the Code accepted by corporations positively and help them make autonomous efforts to increase corporate value.

My point is that the Code should describe essential principle that contributes to continuous increase of corporate value. My earlier opinion on *kansayaku* (Audit & Supervisory Board Member) was also based on the similar logic. *kansayaku* (Audit & Supervisory Board Member) have obligations and rights for corporate governance under the law. Then taking advantage of them, the Code should state what *kansayaku* (Audit & Supervisory Board Member) should do as an essential role. They are expected to play a much broader role from the standpoint to increase the corporate value. I think that the Code is required to properly describe such essential matters. Becoming too obsessed with particular styles could result in losing sight of the essentials, although I don't expect we will become like that. In short, I think we should aim at writing the essentials properly in the Code.

[Ikeo, chairman] Thank you very much.

Ms. Nakamura, please go ahead.

[Nakamura, member] First of all, I basically agree that we should clearly write about *Kansayaku* System (Audit & Supervisory Board) and other systems. As for the applicable scope and how to write the entire Code correspondingly, needless to say, the Code is expected

to be applied to very large companies. Yet regardless of whether it is fully applied to all the listed companies or not, at least the Code should be as such that most listed companies aim at compliance with and implement under. We need to explain the systems mainly to give foreign players a better understanding. Yet the concept of ‘Comply or Explain’ is originally defined in the English language, and thus it should be necessary to explain clearly so that various companies can equally understand the concept.

In doing so, the material handed out today introduced the instances where the UK Code has some variations such as ‘Comply and Explain’, and ‘Comply or Explain.’ In this Council, we started the discussion on the premise that the Code will adopt ‘Comply or Explain’ rule. If the said variations come into play within the Code, it will be difficult to understand. Therefore, this time, I hope the Code will be written in a uniform manner based on ‘Comply or Explain.’

[Ikeo, chairman] Thank you very much.

Please go ahead.

[Takei, member] I just would like to mention one more thing about *kansayaku* (Audit & Supervisory Board Member). Four years ago, I understand that Professor Ikeo prepared a report on corporate governance at the Financial System Council. If I remember correctly, it presented three pictures for illustrative purposes. If we use them as the basis, I think we can explain corporate governance including *Kansayaku* System (Audit & Supervisory Board) in an easy-to-understand way. Please consider using them.

[Ikeo, chairman] They were presented by Mr. Ikeda, not me.

[Takei, member] Oh, I’m sorry.

[Ikeo, chairman] Please go ahead.

[Uchida, member] Let me point out one more thing. Concerning the applicable scope of the Codes explained earlier, I understand that in France, large caps and smaller caps are treated differently. We need to assess this point carefully. It depends on the content of the Code, but if it includes only essential matters which must be complied with, it will be all right to apply it to all listed companies. Yet if the Code is expanded to cover such matters as expected roles, realistically some corporations may not be able to follow it, I’m afraid. Taking it into account, it could be worth considering an option to separate the applicable scope.

Another concern is the timing of the publication of the Code. I understand that since the schedule was already decided by the Cabinet, we cannot do anything about it. Nevertheless, speaking from the corporate side, we have to admit that this is a very tight schedule. Whether a corporation chooses to comply or to explain, it requires time for serious consideration within a corporation. Consequently, in the future procedures, if you have any opportunity to propose extending the time period for implementation, please consider doing so. I assume most corporations consider the schedule is too tight to implement. I will discuss more with various corporations, but I have a sense such an opinion will be dominant. Our company also considers it very difficult. If you have a chance, please propose and discuss an extension or other relief.

[Ikeo, chairman] Please go ahead.

[Ota, member] Thank you for giving me the second opportunity to talk today. I also would like to share my opinion regarding how to define or narrow down the applicable scope, which several members just discussed. At the moment, some members suggest that we should focus only on large corporations or so-called large caps among companies listed on TSE. Taking TOPIX 500 for example, 500 companies are picked up based on the market capitalization as well as the liquidity. They cover approx. 90%. Yet in terms of the number of companies, they account for only approx. 20% - although we should obtain the accurate data later. Given that, while we may exclude the bottom 20% in terms of the market capitalization, can we exclude 80% of listed companies in terms of the number? So I think we should have a careful discussion.

Let me speak from another perspective. I think we have a real problem with how to apply 'Comply or Explain' rule equally to so-called large companies and small and medium-sized companies. The scope of large companies under the Companies Act is rather wide, by the way. TSE and others will start the practical code-making process soon. While we say 'Comply or Explain,' the Code will be, in a certain sense, a hard law instead of soft law for listed companies. Practically, companies which wish to get listed, or small and medium-sized companies, especially smaller ones, which wish continued listing, will have to comply with such a hard law. Then as actual code or standard, what should they comply, or explain if they cannot comply? That is a question. I'm concerned that compliance with the Code will be, in effect, mandatory depending on its stipulation.

Therefore, I fully understand that large caps draw a great deal from stakeholders including foreign and domestic institutional investors. Yet I'm aware of the issue of the uniform application to other companies, as I just mentioned. How should we cope with the issue? For

this discussion, we should look at specific figures including the number of companies. Otherwise, I'm afraid many companies may not be able to follow the Code. You could say it's a problem with companies which cannot follow, but things are not that simple. We should have deeper discussions regarding possible broad measures to cover those companies. For example, as discussed earlier, you could show a high-order philosophy and tell SMEs to observe, because basic principles for corporate governance should be applicable to all companies including SMEs. Or you could establish a separate code for SMEs. I think there are several options. Having said that, I'm not so comfortable with the idea that the Code should be applied only to large caps.

[Ikeo, chairman] In addition, although it relates to the size, probably we need to cover start-up and venture companies; especially ventures as far as Access to Capital is concerned. So I think how to treat them would be one of the points to be discussed.

[Oguchi, member] Sorry to speak many times. After hearing various arguments, I would like to repeat what has been staying on my mind from the beginning. We are given very difficult propositions in the section "Drafting the Corporate Governance Code, etc." of Japan Revitalization Strategy Revised in 2014, that is to "satisfy the interests of the international community while being in alignment with the actual conditions of Japanese businesses." This is exactly related to the discussion just had. It is difficult to express, but I'm afraid that the more aligned with the actual conditions, the less satisfying the interest of the international community. Conversely, if we try to create the Code to satisfy the interests of the international community, it will not be in alignment with the actual conditions of Japanese businesses. Therefore, I personally feel it would be difficult to achieve both goals at once. I think it would be better to prioritize or weigh the importance of the propositions, in other words, to confirm our understanding of the propositions.

[Ikeo, chairman] Thank you very much. Everything inevitably has a trade-off.

Next one, please.

[Oba, member] In connection with the discussion just had, it would be pretty difficult to find how to take in both. Yet how to define the target scope would be a controversial issue. As one of the topics, you could ask each member to draw up the idea, and compile the ideas by the next Council. I believe we need a session to disclose the ideas in that way. I think this is a very difficult topic. This is my first point.

Another point is that the Revitalization Strategy is centered on the theme "restore earning

power.” In my understanding, this Council was established because of a decline in earning power. So if we try to reflect the reality too much, we cannot have a positive discussion. There is a perspective that too much consideration of the actual conditions may have caused the current situation, so I think we need to discuss how to establish the Corporate Governance Code in order to restore earning power. Without such a perspective, I’m afraid that the meaning of the Council will be diluted.

[Ikeo, chairman] Thank you very much.

Professor Kanda, what do you think?

[Kanda, member] Thank you for giving me the opportunity to talk.

I’m afraid my input may not be so important, but I think each item listed in today’s Material 3 is important. As for the scope of application, I was impressed by the wise way the French Code defines it, as explained by the Secretariat, although it looks difficult to import. Then what about Japan? One of the members referred to start-up companies in Japan. Companies listed on the JASDAQ market were not listed companies in the past. They used to be OTC-traded companies. Then the government established the policy to make them listed companies. Given such a historical background, and according to the policy focusing on companies which need to be earnings drivers, the Code should be applicable to those companies, I think.

Nonetheless, for this kind of topic, we need to discuss particulars. It is the same as writing the preamble last, as Professor Ikeo mentioned earlier. So we may be able to discuss general matters to a certain extent at this point, but practically, it would be better to discuss particulars - meaning the body of the Code - first and then return to generals for the final decision or compilation.

[Ikeo, chairman] Thank you very much. I think you are right.

We still have a little more time.

[Takei, member] Excuse me, with regard to the “alignment with the actual conditions of Japanese businesses” which was discussed earlier, I interpreted in a little different way. The objective of drafting the Corporate Governance Code is, absolutely, to restore earning power, as stated in the Revitalization Strategy. And how to earn profits varies among corporations. To put it in a different way, corporations cannot earn profits by doing the same thing with other

corporations. And doing the same thing with others is not viewed as risk-taking. Therefore, the differentiation is crucial. The Code should not deny such differentiation and the reality that there are diverse options in terms of corporate strategies: I believe that's what "alignment with the actual conditions" means.

As explained by the OECD earlier, the OECD Principles of Corporate Governance is written in a way to provide a reasonable framework, within which corporations can choose the means to satisfy goals. Thus, the actual conditions of Japanese businesses mentioned above do not imply any deviation from the reasonable framework. Rather, they refer to the actual conditions of individual corporations with regard to the earning power of individual corporations. When corporations must go for differentiation in various ways to restore earning power, the Code should not be an obstacle to their differentiation strategies. My understanding is that the Code should be in alignment with the actual conditions in order to serve purposes of differentiation strategies.

Accordingly, I did not take "alignment with the actual conditions" and "satisfying the interest of the international community" as a dichotomy between the two. Today's presentation by the OECD reassured me in my understanding. That's all.

[Ikeo, chairman] Yes, please.

[Callon, member] At some point, I usually plunge in and destroy the atmosphere of these kind of big meetings, and now may be the time. With respect to the fundamental purpose and meaning of the proposed Code, what is insufficient in Japan's current corporate governance is not the explanation of Japan's corporate governance. What is insufficient is the content of Japan's corporate governance. Earlier today, Mr. Isaksson very politely explained what kind of problems exist in Japan today. It depends on industry sector, but the first problem is the low productivity of Japanese corporations. The second one is a decline in the competitiveness of Japanese corporations. Another problem is low ROE and excessive retained earnings. In short, the many challenges facing Japanese corporations, however excellent the Code is, the Code will be meaningless if it does not generate change. In short, the fundamental basis of the Code needs to be "change and reform." As an essential element of the government's Japan Revitalization Strategy, the point is how to take actions which are different from the past. Of course, explanations are important, but if we merely focus on explanations, the result will be a failure. I believe this Code is important to improve corporate performance through corporate governance. As I mentioned earlier, the operation of the current *Kansayaku* System is insufficient. However, I would like to argue that the right answer is making effort to get more from the existing *Kansayaku* System, instead of abandoning the current system. Nothing is

meaningful without “change and reform.” That’s why I spoke up, playing the role of “external pressure.” [Laughter] Thank you.

[Ikeo, chairman] That’s why we have been saying that the Code must be outcome-oriented. I assume everyone agrees with that point.

Is there any other input? Any additional opinions to share?

Okay, I would like to close the discussion now. We need to have extremely intensive discussions, and we may not be able to sufficiently discuss things during ordinary meetings. Besides, because all of the members are very busy, it could be difficult for all the members to attend every single meeting. So you could submit an opinion paper like Mr. Mori did today, or send your opinion on a certain topic to the Secretariat via e-mail or something. Of course, we will continue open discussion in this venue, but I would like to ask you to supplement the discussion in various ways including those I just mentioned. I would appreciate your cooperation.

As for the procedures of discussions from the next Council, we will continue to consider the way to organize the discussion, taking your input into consideration. Thank you in advance for your cooperation in this regard.

Finally, I would like to ask the Secretariat to make any necessary announcement.

[Yufu] I have two things to announce. The first one is about checking the minutes of the Council. You may have been aware that we have a smaller table today than the last time. There are so many people who want to observe the Council, but the number of seats available for such public observers is limited due to the space constraint. We are allocating them on a first-come-first-served basis, and in case there are too many delegates from the same organization, we request them to limit the number. The point is there are many people who wished to attend this Council, but could not. Given that, we hope to prepare and make the minutes available to the public as soon as possible. Therefore, when we request you to check the draft minutes, the deadline will be tighter. We would appreciate your understanding of the intent.

Second, the next Council will be on Tuesday, September 30. Although we will inform you of the details later, please note that we are currently planning to hold the Council from 15:30 on Tuesday, September 30. Thank you.

[Ikeo, chairman] Thank you.

I declare the Council closed. Thank you all for attending.

End