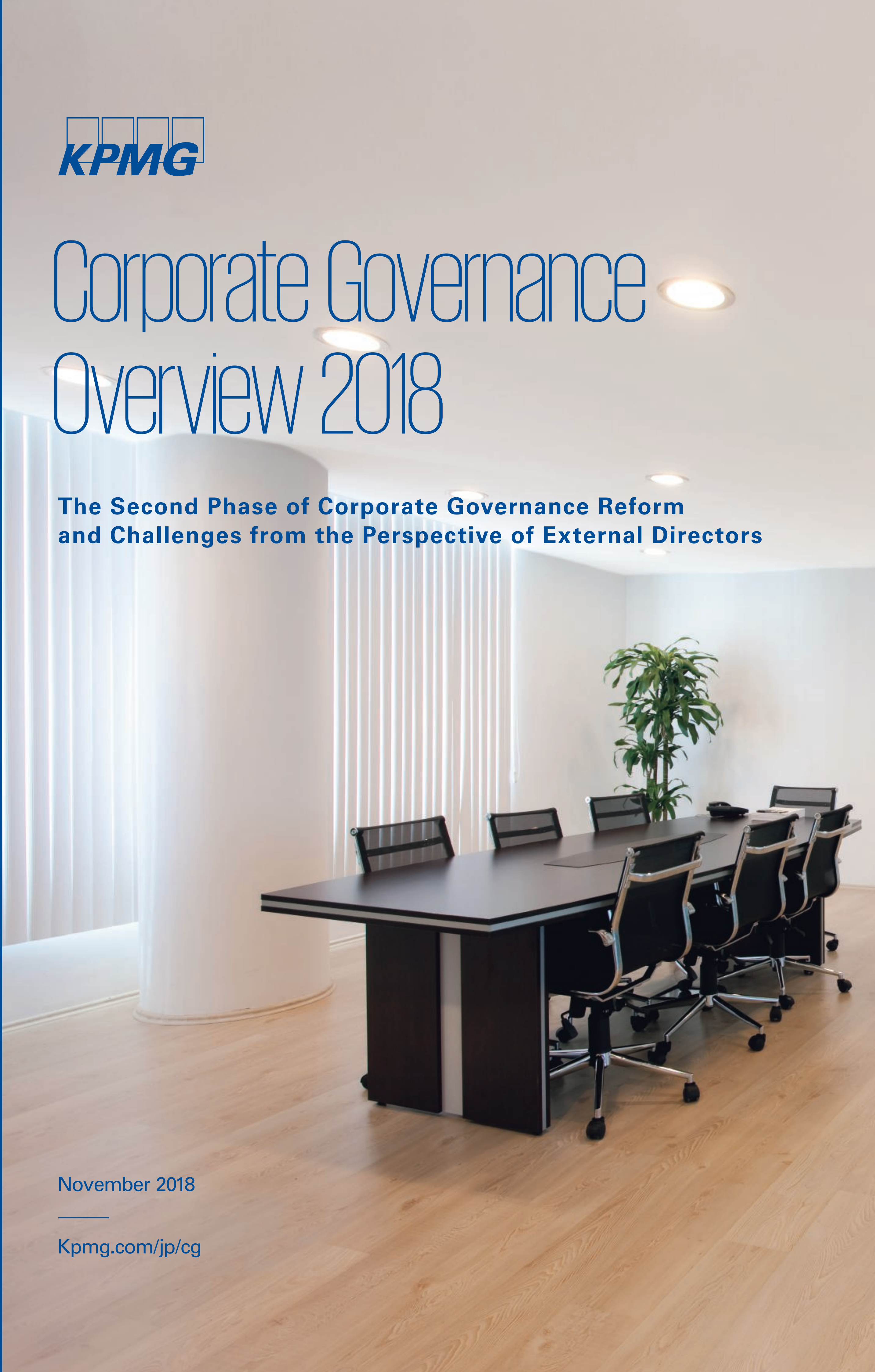


# Corporate Governance Overview 2018

**The Second Phase of Corporate Governance Reform and Challenges from the Perspective of External Directors**

November 2018

Kpmg.com/jp/cg

# On the Publication of Corporate Governance Overview 2018

The year 2018 is a milestone for corporate governance reform in Japan. The Corporate Governance Code responsible for setting the direction of reform was revised for the first time in three years, and application of the revised code has started since June 2018. The "Guidelines for Investor and Company Engagement" has also been published as an appendix. The revision is aimed at evolving the reform for a more practical application, and shows that Japan's corporate governance reform has entered the Second Phase.

External directors will have a more important role in promoting reform in the Second Phase. In line with the reform, the number of external directors in Japanese companies has been increasing significantly. Understanding the current situation and challenges of the Board of Directors from the perspective of external directors is essential to effectively enhance the function of the Board of Directors and develop ideas on how to improve corporate value.

KPMG Japan has been publishing the "Corporate Governance Overview" every year since 2016. The Overview highlights issues in corporate governance reform in various ways through incorporating awareness survey responses, and provides proposals for a more practical reform.

In publishing the Corporate Governance Overview 2018, we conducted a questionnaire-based awareness survey on the issues of the Board of Directors from the perspective of external directors, in taking into account the Second Phase of Japan's corporate governance reform. The results revealed the thoughts of external directors in dealing with their tasks, and challenges in the revised Corporate Governance Code.

In this brochure, specialists of KPMG Japan in various areas related to Corporate Governance provide their analyses and insights based on the survey results. We hope that our analyses and observations can be effectively applied to initiatives for raising the corporate value of Japanese companies.

November 2018

KPMG Japan CEO
**Hiroyuki Sakai**

# Summary and Key Findings of External Director Awareness Survey

With respect to the revised Corporate Governance Code (the "revised Code") and the Guidelines for Investor and Company Engagement, KPMG believes the following 4 points are key for promoting reform in the Second Phase; (1) Ensuring diversity in the Board members; (2) Strengthening procedures for CEO appointment/dismissal and determination of compensations and utilizing independent nomination/compensation committees; (3) Management focused on cost of capital; and (4) Initiatives to promote the role of a plan sponsor as the asset owner of the corporate pension fund.
The summary and key findings of the external director awareness survey on these points are outlined below.

## 1 Ensuring diversity in the Board members

■ External directors are required have the ability to identify potential risks to achieve sustainable growth and increase corporate value over the medium-to-long term. As such, the Board of Directors requires members with diverse management experience and professional knowledge. Many external directors see the formulation of long-term visions as a challenge in risk-taking.

- 77% of external directors prioritize the viewpoint of risk control over risk-taking in fulfilling their responsibilities.
- 89% of external directors cited the development of long-term visions as a challenge in risk-taking. More than 60% emphasize changing their business portfolio and increasing capital efficiency.
- 84% of external directors believe the prevention of scandals to be most important for risk control. Over 50% place value on stricter assessments of investment risks, strengthening governance of subsidiaries and maintaining financial soundness.
- 85% of external directors place priority on the ability of questioning to identify potential risks in daily operations.
- External directors emphasize the importance of increasing talents with management experience (75%) and those with expertise in specialized fields (55%) as members of the Board of Directors.
- An increasing number of external directors responded that they believe the appropriate term for external directors to fulfil their responsibilities is five years or more, and the appropriate number of companies for which they concurrently serve should be three or less.
- A considerable number of external directors recognize the necessity of preparing for resolutions at board meetings in advance, including preparations such as on-site inspections and feedback, and discussions in informal settings other than board meetings.



## 2 Strengthening procedures for CEO appointment/dismissal and determination of compensation and utilizing independent nomination/compensation committees

■ External directors focus on clarifying the procedures for appointments and dismissals of the CEO, and CEO succession plans. While the revised Code clearly calls for the voluntary establishment and use of an independent advisory committee, not many external directors showed a high awareness for the proactive use of such a committee.

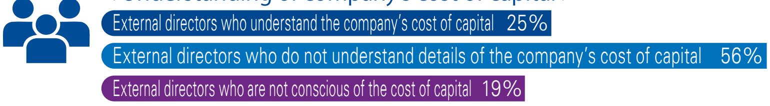
- On the CEO succession plan, 71% of external directors responded that they find issues in the following: (1) Succession plan for candidates, (2) Clarifying the selection procedure and (3) Clarifying requirements for successors. In particular, the number of external directors raising (1) Succession plan for candidates as an issue is increasing.
- Only 17% of external directors believe that using the nomination committee for the succession plan is necessary.
- 29% of external directors responded that the transparency of discussions in the procedure for dismissals, including the utilization of a nomination committee, is an issue.
- 47% of external directors responded that performance-based compensation is most important in regards to the compensation policy. On the other hand, 20% of external directors leave the compensation policy to the discretion of management members, and do not make any judgments on their own.

## 3 Management focused on cost of capital

■ It is possible that external directors are unable to provide sufficient statements based on a clear understanding of the company’s cost of capital at board meetings, due to reasons such as the company not calculating its own cost of capital. The quantitative verifications of cross-shareholdings are not performed, and clarifying the purpose and policy of cross-shareholdings is urgent.

- 81% of external directors believe their opinions should be expressed at board meetings based on an awareness of the company’s cost of capital. However, 56% of external directors do not understand the details of their company’s cost of capital.
- 49% of external directors feel that the purpose and policy of cross-shareholdings should be clarified. Only 21% of external directors raised quantitative verification of cross-shareholdings as an issue, revealing the reality in which quantitative verification is not performed due to a lack of a clear purpose and policy on cross-shareholdings.

< Understanding of company’s cost of capital >




## 4 Initiatives to promote the role of a plan sponsor as the asset owner of the corporate pension fund

■ Although a plan sponsor is required to proactively monitor its corporate pension, external directors do not have a sufficient understanding of the corporate pension.

- While 30% of external directors responded that they feel efforts to strengthen operations such as the supervision of institutional investors (asset managers) is an issue, 26% responded that they are not aware of the current status of the operation of the corporate pensions.

< Issues in fulfillment of Stewardship responsibility for corporate pension >

# KPMG's Recommendation

## Ensuring diversity in the Board of Directors from the viewpoint of increasing corporate value

When considering how to ensure diversity in the Board of Directors, it is important to keep in mind that the Board of Directors should consist of members with the necessary knowledge, experiences and abilities in aiming for sustainable growth and increased corporate value over the mid-to-long-term.

Although "gender" and "international background" may play important roles in ensuring diversity, inclusion merely as a formality will not secure true diversity for the Board of Directors.

The results of the external director awareness survey revealed that external directors believe the Board of Directors require members with management experience or with expertise in specialized fields. While the majority expressed that risk-control is an important role of external directors, many also raised the ability of questioning to identify potential risks as a necessary quality of external directors, explaining why they feel the Board of Directors need members with management experience and expertise in specialized fields.

External directors expressed that the development of long-term visions is important for risk-taking. Each company should formulate a long-term vision and thoroughly examine the appropriate composition of its Board of Directors in achieving this vision.

## Utilizing an arbitrary advisory committee for CEO appointment/dismissal, succession planning and determination of compensations

With respect to the CEO succession planning, it is necessary to explicitly define the requirements of CEO candidates based on a competency model or the like, and implement policies on succession planning in line with the cultivation and selection of employees, as well as clarify the procedures for CEO appointments and dismissals. In order to guarantee the objectivity and transparency of these procedures, the establishment of an independent advisory committee is useful. However, not many external directors recognize the necessity of using an advisory committee, including independent external directors.

While many external directors were highly conscious of a performance-based compensation system, their awareness on utilizing an advisory committee for more transparency in the decision process of compensations was similarly low.

External directors will need to influence the Board of Directors on improving efforts to ensure transparency in the CEO succession planning and the process of appointments and dismissals and determining compensation, including the utilization of an advisory committee

## Promoting business management based on an understanding of cost of capital

While many external directors were aware of cost of capital, they were unable to express their opinions based on a full understanding of the company's cost of capital at board meetings due to reasons such as the company not calculating its cost of capital.

In addition to being a hurdle rate in risk-taking, cost of capital also has the aspect of a risk proxy indicator based on the company's optimal capital structure to determine if the company can withstand downside risks of company performance.

A company needs to establish an operational structure pursuing returns corresponding to business risks by strengthening and promoting the cost of capital-oriented business operations.

External directors are in a position to encourage management awareness of cost of capital at the Board of Directors meetings. While they should actively promote companies to understand their cost of capital in their role as external directors, they also need to request financial control and business portfolio management, and establish policies on the evaluation of cross shareholdings.

## Necessity of understanding actual situation of corporate pension to function as asset owner

The revised Code requires that a plan sponsor is fully aware of the actual status of its corporate pension and supports the realization of Stewardship activities.

The external director awareness survey, however, revealed that a certain number of external directors do not have a sufficient understanding on the actual status of the company's corporate pension.

External directors need to request explanations on the status and support of the corporate pension, as well as the method for managing any conflict of interests at the Board of Directors meetings. They also need to appropriately monitor the corporate pension so that it functions in achieving Stewardship responsibilities with the plan sponsor as the asset owner.

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# Ⅰ.

# Corporate Governance Entering the Second Phase

# 1 Overview and key points of the "Second Phase" of Corporate Governance Reforms



## 1-1 Overview of the "Second Phase" of reforms

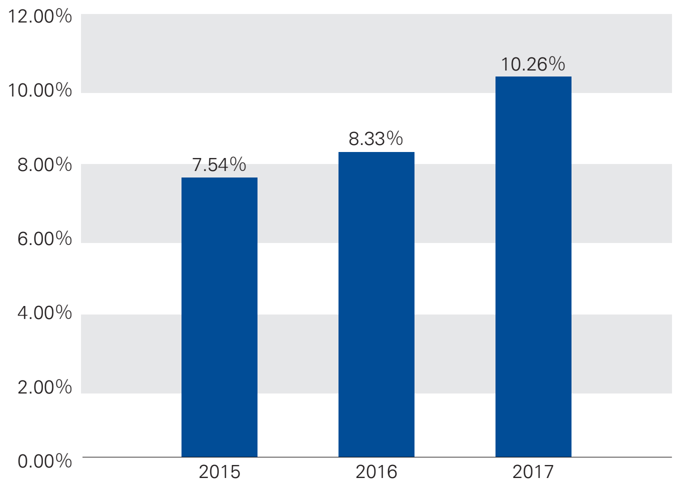
Corporate governance in Japanese companies has undergone a major transformation following the establishment of the Stewardship Code and release of the Ito Review in 2014, and implementation of the Corporate Governance Code in 2015. These initiatives have resulted in improved profitability in Japanese firms. Ever since 2015, the ROE in Japanese companies has remained solid, due to a series of corporate governance reforms that promoted changes and created a virtuous cycle that led to improved performance (Figure I-1).

Meanwhile, the management today is expected to make bold business decisions amid intensifying global competition and a business environment that changes radically and discontinuously. Furthermore, some observers point out that the dialogue between companies and investors still remains a mere formality. Against this backdrop, Japan's corporate governance is entering the "Second Phase," and moving on to new levels of effectiveness.

Specifically, the Corporate Governance Code was revised on June 1, 2018 for the first time since its establishment. Furthermore, "the Guidelines for Investor and Company Engagement" (referred to as "Engagement Guideline") was released as an appendix to the Corporate Governance Code and the Stewardship Code (Figure I-2).

The Engagement Guideline describes agenda items expected to be discussed in the dialogue between institutional investors and companies with an aim to achieve sustainable growth and enhance corporate value over the mid-to-long term. It is intended to effectively promote the "comply or explain" concept of the Stewardship Code and the Corporate Governance Code. When companies comply with the principles of the Corporate Governance Code (including disclosure of information required by the principles), or explain the reasons for non-compliance, they are expected to consult the purpose of the Engagement Guideline.

■ Figure I-1. ROE trend of listed companies




Source: Japan Exchange Group, Inc. "Summary of Earnings Digests for FS 2017 (April 2016 – Mar 2017), and FS 2016 (April 2015 – March 2016). Figures for 2015 and 2016 have been compiled by retroactively aggregating the data of listed companies for 2016 and 2017.

## 1-2 Key points of the revised Code

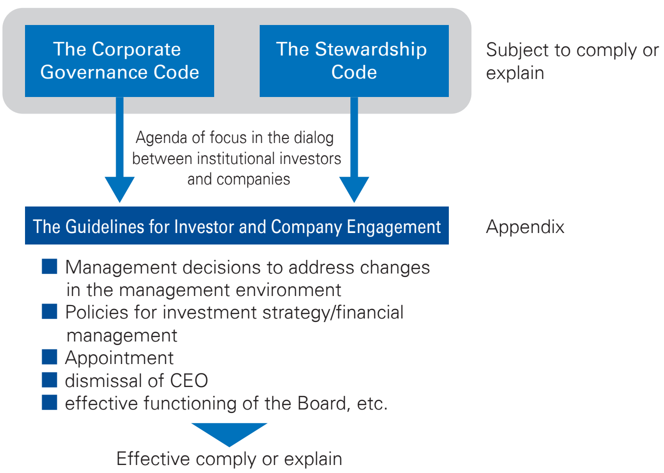
The key revisions can be summarized into the following four points.

1. Ensuring diversity in the Board members
2. Strengthening procedures for CEO appointment/dismissal, succession planning and determination of compensation and utilizing independent nomination/compensation committees
3. Management focused on cost of capital and disclosure of policy/approach for reduction of cross-shareholdings
4. Initiatives to promote the role of a plan sponsor as the asset owner of corporate pension funds

## Ensuring diversity in the Board members, etc.

The Board of Directors is expected to possess the right level of knowledge, experience, and ability as a whole. In Japan, the percentage of female executive directors in listed companies stands at a mere 3.8% (source: KPMG Japan "Corporate Governance Survey 2017"). As such, the revision dictates that the Board should be constituted in a manner that achieves both diversity, including gender and international background, and appropriate size (principle

■ Figure I-2. The Guidelines for Engagement between Investors and Companies



4.11) in order for the Board to fully perform its function.

In addition, as a precondition for securing effectiveness in the Board, persons with appropriate experience and skills as well as necessary knowledge of finance, accounting, and the law should be appointed as the auditors (principle 4.11).

Moreover, with respect to independent external directors, prior to the revisions, if a listed company believed it needed to appoint at least one-third of directors as independent external directors based on a broad consideration of factors such as the industry, company size, business characteristics, organizational design and circumstances surrounding the company, it was considered sufficient as long as the company disclosed a roadmap for doing so. However, the revision stipulates that in addition to the above, the company should appoint a sufficient number of independent external directors (principle 4.8). Although there have not been major revisions to the code in this respect, some institutional investors have started calling for a minimum one-third board independence in companies that do not meet this threshold, and use it as a criteria for their approval or disapproval of the Board member nomination.

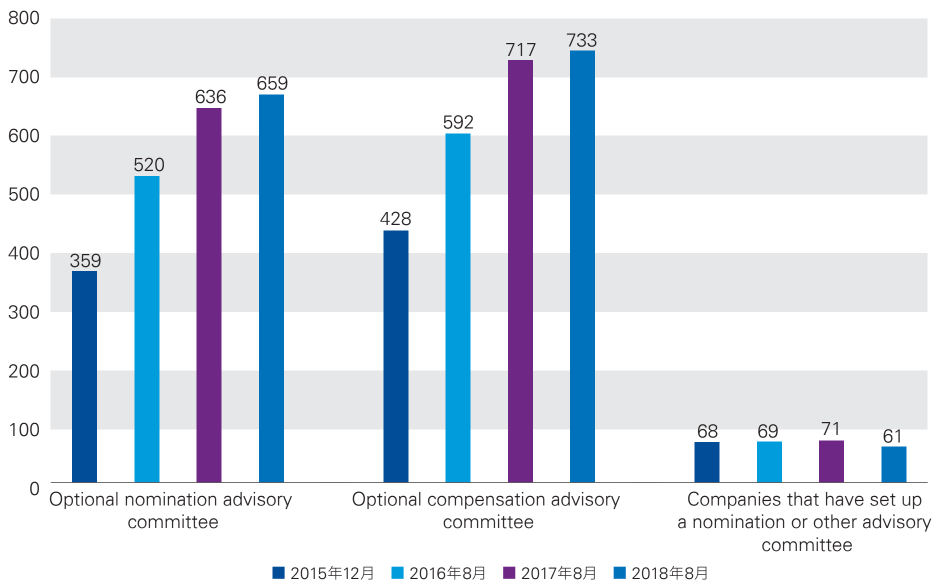
## Strengthening procedures for CEO appointment/dismissal, succession planning and compensation determination; use of independent nomination/compensation committees

The appointment or dismissal of the CEO is one of the most important strategic decisions for a company. In spite of this fact, many organizations lack a sufficient approach. Some observers point out that the appointment and dismissal procedures in companies lack transparency. For this reason, the revised code stipulates that the companies should disclose and proactively provide the information related to policies, procedures and reasons for individual appointments or dismissals of senior management including the CEO (principle 3.1).

The revisions also urge the Board to practice a more effective nomination/dismissal of the CEO. Specifically, the Board should nominate a qualified CEO through objective, timely and transparent procedures in deploying sufficient time and resources. Also, when a CEO is judged as not adequately fulfilling its responsibilities based on an appropriate evaluation of the company's business results, the Board should establish an objective, timely and transparent procedure to dismiss the CEO (supplementary principle 4.3.2 and 4.3.3)

Since there are a limited number of companies in which the Board is involved in the appropriate oversight of

■ Figure I-3. Establishment of optional advisory committees




Source: Compiled by KPMG based on KPMG Japan's "Corporate Governance Survey 2017" and Tokyo Stock Exchange's "Appointment of Independent external directors, Establishment of Nomination and Compensation Committees, and Disclosure of Sodanyaku, Komon etc. (i.e. Former President・CEOs Holding Advisory Positions) by TSE-Listed Companies (July 31, 2018)" succession planning, the Board should proactively engage in the establishment and implementation of the succession planning for the CEO and other top executives and appropriately oversee the systematic development of succession candidates, in deploying sufficient time and resources. (Supplementary principle 4.1.3)

Moreover, since there had been opinions pointing out that the management compensation systems are not operating as a healthy incentive, the Board should design management compensation systems and determine actual compensation amounts appropriately through objective and transparent procedures. (Supplementary principle 4.2.1)

In order to strengthen the independence and objectivity of CEO appointments and dismissals and compensation determination procedures, it is important to further promote the establishment and use of nomination or compensation committees. Prior to the revision, in companies with a Board of Corporate Auditors or companies with an Audit and Supervisory Committee, when the number of independent external directors in the Board falls short of a majority, the establishment of an optional advisory committee was only presented as an example. According to the revised code, companies should seek appropriate involvement and advice from independent external directors by establishing independent advisory committees such as optional nomination/compensation committees (supplementary principle 4.10.1). Today, the number of companies setting up optional advisory committees is increasing every year after the Corporate Governance Code came into effect in 2015. (Figure I-3)

## Management focused on cost of capital and disclosure of policy/approach for reduction of cross-shareholdings

Not all Japanese companies are appropriately making adjustments to their business portfolio. Some point out that it may be attributable to an inadequate awareness of cost of capital on the part of the management.

In response to such indications, the Code clearly describes the importance of making bold management decisions, including adjustments to the business portfolio, as well as having an accurate awareness of cost of capital to facilitate sound management decisions (principle 5.2)

It is also important for companies to strategically and systematically invest in fixed assets, R&D and human resources to achieve sustainable growth and increase corporate value over the mid-to-long term. This is why adjustments to the business portfolio, investments in fixed assets, R&D and human resources are included in the supplementary notes to shareholders (principle 5.2).

In recent years, cross-shareholdings are on the decrease, but their volume as a proportion of total voting rights still remains large. With respect to cross-shareholdings, while they serve a purpose of inter-company strategic alliance, others point out that stable shareholdings is perhaps causing the weakening of managerial discipline, or lower capital efficiency. Given this, the revised Code stipulates that companies should disclose policies/approaches regarding the reduction of cross-shareholdings (Principle 1.4). Furthermore, for each "individual" cross-shareholding, a company should annually assess whether or not to hold each individual cross-shareholding by specifically examining whether the purpose is appropriate, and whether the benefits and risks from each holding cover the company's cost of capital, etc., and disclose the results of this assessment.

In relation to cross-shareholdings, some observers pointed out the importance of disciplinary rules on the part of the "companies letting shareholdings", leading to the addition of rules prohibiting the hindrance to sales of cross-held shares by, for instance, implying a possible reduction of business transactions (supplementary principle 1.4.1, 1.4.2)

## Initiatives to promote the role of a plan sponsor as the asset owner of the corporate pension fund

In order to deepen corporate governance reforms and promote the full performance of the investment chain function, the role of asset owners is extremely important as they are in the closest position to the final beneficiaries and can approach or monitor institutional investors, who are the direct counterpart in the investor-company dialogue. Unfortunately, it was pointed out that the stewardship activities for corporate pensions is insufficient.

With respect to this issue, because the management of a corporate pension fund impacts the formation of a stable asset for employees and the company's own financial standing, the revised code stipulates that plan sponsors should take and disclose measures to improve human resources and operational practices, thus making sure that plan sponsors perform their roles as asset owners (principle 2.6).

Theoretically, corporate pension funds are supposed to be responsible for these actions, but since the management of corporate pension funds may impact the formation of employee assets and the financial standing of plan sponsors, the plan sponsors are expected proactively work on the improvement of human resources and operational practices and drive improved support for stewardship activities.

Section 3 of the Corporate Governance Code focuses on information disclosure. The principle 3 specifies that companies should strive to actively disclose non-financial information. Today, there is a growing demand for disclosure of ESG information such as those related to sustainability due to the significance of their impacts on corporate value. In response to this demand, the revised Code clearly states that non-financial information also includes information related to ESG elements.

This section discussed the overview on the "Second Phase" of corporate governance reforms. The next section will focus and discuss key points and actions related to each revised item of the Corporate Governance Code along with KPMG's insights.

# 2 The key points and actions related to revised items of the Corporate Governance Code

## 2-1 Ensuring diversity in the Board of Directors

### Implication of diversity in the Board

The revised Code stipulates that "the Board should be constituted in a manner that achieves both diversity, including gender and international background, and appropriate size". 'Japanese males aged 50 or older' account for most Boards members at Japanese companies. This distinctive homogeneity is said to have provided strength for the old management environment. At a time when the management environment is undergoing drastic changes, oversight of diverse talent with different points of view is expected to contribute to sustainable growth of companies.

### The Boards of the US companies facing the challenge of 'digital shift'

In the US, diversity in the Board members is also an important agenda, but its nature is different from that of Japan. The US companies are said to have been making ongoing efforts on gender equality issues for a long time. While the percentage of female executives in the US have reached 20%, the counterpart in Japan is only 3.8%.

Japan has only just set its goal at 10% by 2020 (Japan's 4th gender equality basic plan).

In the US, a very major issue being raised with respect to the Board gender equality is the lack of talent possessing knowledge and experience to address digitalization issues. At the US seminars for executives, agendas such as cyber security, utilization of AI, etc., are frequently discussed.

While the revisions focus on keywords such as 'gender' and 'international background', the Engagement Guideline calls the Board to possess appropriate knowledge, experience, and skills as a whole to contribute to 'sustainable growth and the increase of corporate value over the mid-to-long term'. The issue presented in the US example may have been driven by a sense of the criticality of the Board as a whole possessing the appropriate knowledge, experience and skills to address risk (digital shift) in order to increase corporate value.

A close look at the personal trait of the independent external directors in listed companies in Japan reveals that approximately 60% constitutes 'persons from outside organizations' (Figure I-5), a majority of whom have experience in corporate management. It suggests that business practitioners who have first-hand experiences in dealing with risks in business management are more valued than professionals in specific fields, such as attorneys, accountants, or scholars. To address various risks and increase corporate value in a business environment that continues to change in the future, it is important for the Board as a whole to be equipped with the knowledge and experience necessary to address a broad range of risks. Instead of increasing diversity superficially by appointing female or foreign nationals as directors, it is desirable to ensure diversity in the Board from a risk management perspective.

■ Figure I-4. Appointments of female directors (including corporate officers and executive officers)

| 2016 | 2017 |
|---|---|
| 3.4% | 3.8% |

Source: KPMG Japan's 'Corporate Governance Survey 2017'

■ Figure I-5. Independent external director attributes

| Attribute | ratio |
|---|---|
| Persons from outside organizations | 62% |
| Attorney | 15% |
| Scholar | 8% |
| CPA | 8% |
| Tax accountant | 2% |
| Other | 5% |

Source: KPMG Japan's 'Corporate Governance Survey 2017'

## How to promote diversity in the Board?

Based on the purpose of the Engagement Guideline, we can say that diversity in the Board may vary greatly for individual companies depending on the approach they are aiming for. It is important to organize ideas on how diversity, including 'gender' and 'international background', contribute to increasing corporate value, rather than focusing on formalities.

In order for the Board to equip itself with the knowledge, experiences and skills necessary for achieving sustainable growth and enhancing corporate value over the mid-to-long term, the 'knowledge, experience and skills' required of the Board must be defined in the first place. In doing so, the business environment must be examined in a mid-to-long term time frame, rather than looking only at current conditions. With this in mind, when and to what extent the Board's knowledge, experiences, skills must be acquired should be defined in the form of a portfolio with a set timeline. The Board should eventually be able to ensure the desired level of diversity by using this portfolio as a basis for achieving a sound practice in the selection and appointment of internal and external directors.

Every director has a term of service, and therefore will required successors when their terms ends. Ensuring diversity in succession planning should also be considered. Ensuring the diversity of employees from a perspective of talent management is what supports diversity in the Board over the mid-to-long term.

Furthermore, with respect to diversity in the Board, independent external directors need to oversee the above-mentioned 'organization of ideas on the relationship between corporate value enhancement and diversity,' and 'diversity in the context of a portfolio with a mid-to-long term time frame' with considerations for investor expectations. Directors are expected to inquire and provide counsel from these perspectives in the Board of Directors meetings, nomination committees, etc., and make recommendations for a successor with diversity in mind.

## 2-2 Appointment/dismissal of CEO and determination of compensations (including succession planning)

### Importance of ensuring objectivity and independence in the appointment/dismissal of CEO and determination of compensations

The revised Code focuses on ensuring objectivity and independence in the appointment or dismissal of CEO, the succession planning, and determination of compensations, with the aim to promote sound decision-making in eliminating arbitrariness. The following are key points of the revisions that would require many companies to take action.

- Establishment of the criteria for the appointment or dismissal of CEO and the objective, timely and transparent procedure for CEO appointments and dismissals (supplementary principle 4.3.2, 4.3.3)
- Establishment of a succession plan for CEO (supplementary principle 4.1.3)
- Designing compensation systems and determining actual compensations based on objectives and transparent procedures (supplementary principle 4.2.1)
- Optional establishment of a nomination or compensation advisory committee in companies with a Board of Corporate Auditors and companies with an Audit and Supervisory Committee (supplementary principle 4.10.1)

## Getting a full picture of key action points in addressing CEO appointment/dismissal and succession planning

To address code revisions, companies need to establish the criteria for appointments and dismissals and a succession plan, and organize an operating structure (Figure I-6).

### ■ Figure I-6. A full picture of key actions in addressing CEO appointment/dismissal and succession planning

**Establish criteria for CEO appointment**

What are the skills/experiences/competency required for a CEO?
- Criteria for skills, experience and competencies required for a CEO

**A succession plan (develop a succession plan)**

What are the processes/procedures for people development of candidates?
- Assessment process of candidates, etc.
- People development processes/tools
- Monitoring procedures

**Establish criteria for CEO dismissal**

What are the conditions for dismissal of CEO?
- Judgment criteria for dismissal discussions such as past business results, legal violations, etc.

**Organizing operating structure**

What structure and processes will be deployed in the approval of CEO candidates?
- Approval structure (nomination advisory committee, etc.)
- Approval process

### (1) The approach on criteria and procedures for CEO appointments/dismissals

Establish the level of performance, knowledge, experiences, quality, competencies, etc., required for a CEO. It is important to be specific in identifying the knowledge, experiences, quality, etc., for individual requirements as to facilitate a clear visualization of a candidate. When determining candidate requirements, the competency model focusing on the leadership required of a CEO would be a good reference (Figure I-7).

Next, establish the judgment criteria for CEO candidates in considering the company's strategies, internal/external environments, etc. For instance, companies may define the specific level of contribution a candidate's past performance must attain in relation to the 'degree of contribution to business results', or the nature and level of experiences one must have accumulated under the 'business experience' criterion. A company then creates the first short list of CEO candidates from a pool of talent (current top executives), and starts successor development and monitoring. Monitoring will be performed with a multilateral approach using the results of performance evaluations, 360-degree evaluations, etc., against candidate requirements.

After these procedures, the final candidate is selected. In the selection process, preference is not given to internal candidates, if choosing an external candidate is a viable option in considering the company's business environment.

### ■ Figure I-7. KPMG Global Leadership Competency

| Item | Description |
|---|---|
| Has Self-awareness | Clearly and accurately aware of one's strengths and weaknesses and continuously works on self-improvement. Inquisitive, and always strengthening one's expertise. Understands the influence of one's behavior on others and acts with dignity. Proactively seeks others' feedback to re-examine one's behavior. |
| Collaborates | Creates synergy through organic collaboration and coordination across the organization to accomplish one's goals. Thinks beyond one's own interest and considers needs of the entire organization. |
| Thinks Ahead | Predicts future needs of the business and clients to take appropriate actions. Looking ahead, anticipates potential business opportunities and issues. Before taking actions, thinks about alternative plan or expected outcomes of the action. |
| Leads Changes | Leads innovation by presenting a promising future vision. Working towards the desired future vision of the organization, prioritizes actions to be taken, clearly defines goals and acts systematically. |
| Drives for Results | Holds oneself accountable for performance improvements. Seeks opportunities for continuous improvements and optimizes existing processes, framework and deployment of talent. Owns daily performance results, capitalizes on judgment and experiences and willing to improve one's performance. |

**(2) The approach for CEO succession planning**

In the selection of CEO, the establishment of succession planning from a mid-to-long term perspective is also needed. The key to continuously elect a CEO, in addition to performing people development and monitoring executives and managers, is to develop/monitor high potential young employees (fifth year of employment or longer) and leadership talent (chiefs, managers). Some companies have created a list of candidate successors from the pool of talent or is working on individual successor development procedures. Establishment of a system for succession planning, in line with employee development/selection scheme, is considered ideal.

**(3) Approach for the criteria/procedure for dismissal of CEO**

There are both quantitative and qualitative aspects to the criteria for dismissals of CEO. In the quantitative aspect, when a company's performance (ROE, ordinary profits, share prices) deteriorates over a multi-year period, discussions focus on whether the CEO's operation is the primary cause, or if there is room for improvement. In the qualitative aspect, when a CEO incurs damage on the company due to a violation of the law or bylaws (including harassments), the discussions focus on whether there had been a clear presence/absence of knowledge, competencies, or qualities.

As in the nomination of CEO, where one's meeting of nomination criterion does not constitute automatic awarding of the position, just because a person meets conditions for a dismissal does not mean his/her dismissal will be automatically placed before the Board of Directors meeting. The dismissal criterion is likely to be used as a starting point that triggers an examination or discussion over the dismissal of the present CEO.

Items 1, 2, and 3 are likely to be examined/deliberated in the nomination committee, and recommendation delivered from the discussions will then be used as reference in the final judgment in the Board of Directors meeting. The business results, one of the criteria of an appointment or dismissal, will be reviewed by the compensation committee. It is then shared with the nomination committee to be considered in the appointment/dismissal deliberation.

## A full picture of key points in the compensation determination procedure

The revised code calls for clarity and transparency of the compensation system and decision-making procedure for individual compensation amounts.

With respect to the compensation system, many companies have adopted a system linked to mid-to-long-term performance results as a mean to promote appropriate risk-taking by the top executives. On the assumption that the absolute standard of compensation amounts for executives of Japanese companies are lower than their foreign-affiliated counterpart, careful examination must be carried out as to what percentage should be designated as variable compensation, how closely it should be linked to performance, etc., by balancing between the healthy motivation for executives and accountability to investors. It is desirable that changes to the compensation system be made in the compensation committees through a transparent process.

As with the decisions related to individual compensation amounts, the key to transparency is to first discuss it in the compensation committee, then obtain approval of the Board of Directors' meeting. In the actual practice, a decision-making process is carried out in the following workflow:

- Compensation committee's approval on details of each director's target
- Compensation committee's review of each director's performance results
- Based on the results of performance review and the individual compensation proposal (calculated according to the rules of the compensation system), the compensation committee produces its version of compensation proposal and submits it to the Board of Directors meeting (in some cases, the workflow takes the form of an approval on the president's original proposal by the compensation committee)
- Final approval on the compensation proposal (the total amount as a proposal at the general shareholders' meeting) in the Board of Directors meeting

## Establishment and utilization of optional nomination/compensation committees

As previously mentioned, the establishment of independent advisory committees, such as an optional nomination committee or an optional compensation committee, is essential to secure the objectivity and independence of the Board of Directors in the appointments/dismissals, succession planning, and compensation determination of the CEO.

The revised Code states that, if independent directors of a company do not account for a majority of the Board of Directors, the company should establish independent advisory committees under the Board of Directors to seek appropriate involvement and advice from the independent directors when examining such important matters as the nomination and compensation of the CEO of a company. Therefore, it is recommended that independent directors of the company account for a majority of each advisory committee on nominations and compensations of the CEO in order to enhance the independence and objectivity of the Board of Directors.

On the other hand, independent directors of a company tend to lack information on past achievements and the personality of CEO candidates. The company needs to provide each committee member with sufficient information on the candidates. In order to ensure the effectiveness as a committee, the company must make sure that members of the said committees are provided with not only the information in writing but opportunities of direct communication with each candidate, such as meeting him/her face to face or listening to his/her presentation.

## 2-3 Bringing focus on cost of capital within management

## Cost of capital as a proxy for expectation and risk

Principle 5-2 of the revised Code requires that a company should 'accurately identify its cost of capital' when formulating and disclosing its business strategies and business plans. According to the annex of the revised Code, 'Guidelines for Investor and Company Engagement', a company should pay attention to its cost of capital at the following cases:

(1) Where a company identifies its cost of capital (The Engagement Guidelines 1-2)

(2) Where a company sets targets on profitability and capital efficiency (The Engagement Guidelines 1-2)

(3) Where a company restructures its business portfolio (The Engagement Guidelines 1-3)

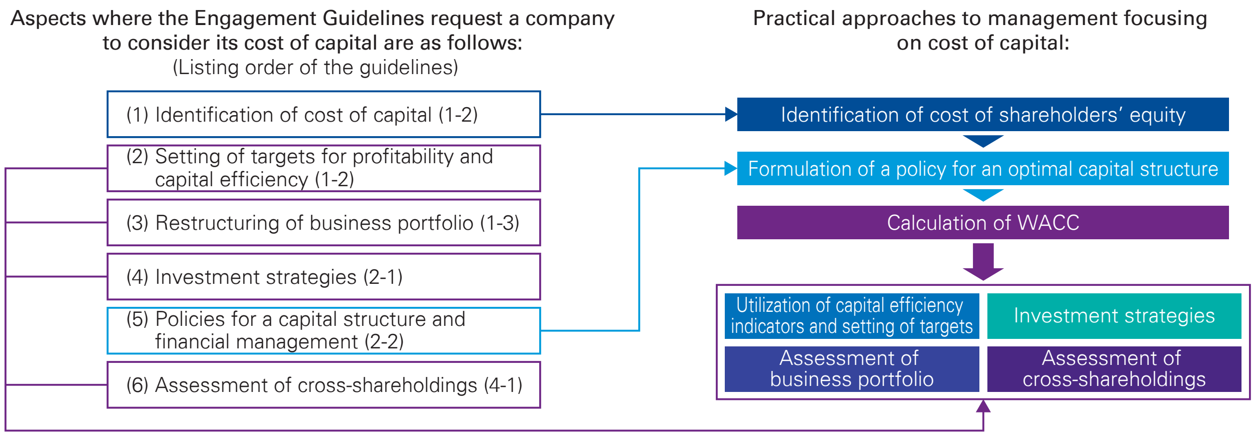
(4) Where a company implements its investment strategies (The Engagement Guidelines 2-1)

(5) Where a company formulates and implements policies for its capital structure and financial management (The Engagement Guidelines 2-2)

(6) Where a company assesses its cross-shareholdings (The Engagement Guidelines 4-1)

Cost of capital is equivalent to the expected rate of return, which is the profit or loss investors anticipate on their investment in a company, and also must reflect business risks of the company accurately. This means that cost of capital is a proxy reflecting investors' expectation and risk.

■ Figure I-8. Approach toward management focused on cost of capital



Cost of capital can be broadly divided into three categories — debt cost for interest-bearing liabilities, cost of shareholders' equity which is shareholders' expected rate of return, and weighted average cost of capital (WACC) which is a weighted average of these costs based on the company's capital structure. Debt cost shows practical interest costs for borrowing and corporate bonds, which a company can identify easily. Cost of shareholders' equity is the shareholders' expectation overall and, in practice, the cost must be estimated using the capital asset pricing model (CAPM). Actually, however, the cost of capital calculated with CAPM tends to remain at a lower level than the market expectation on the whole.

WACC varies depending on a capital structure of a company, that is to say, the percentages of interest-bearing liabilities and shareholders' equity. Furthermore, if a company does not have a clear policy for the above (5), WACC of the company does not reflect its risks accurately. In other words, it is essential for a company to identify cost of shareholders' equity taking into account the market expectation and develop a policy for an optimal capital structure as a prerequisite for management focused on cost of capital.

Consequently, in order to carry out management focused on cost of capital, it is important for a company to identify its cost of capital for the above (1) and (5), and then link it to (2) target setting of profitability and capital efficiency, (3) restructuring of business portfolio, (4) investment strategies, and (6) assessment of cross-shareholdings (Figure I-8).

## Difference in the perception of cost of shareholders' equity between institutional investors and companies

The Engagement Guidelines request a company to firstly identify its cost of capital accurately (Figure I-8 (1)).

The Ito Review published in 2015 shows the survey results that the expected rate of return (cost of shareholders' equity) for Japanese companies by overseas institutional investors averaged 7.2% while the expected rate of return by Japan-based institutional investors averaged 6.3%. Meanwhile, the survey conducted by the Japan Investor Relations Association (JIRA) shows that the cost of shareholders' equity which Japanese companies recognized averaged 6.62% in 2016 and 5.98% in 2018 ('Fact-finding survey of IR activities' April 2016 and April 2018).

There are various factors which cause a discrepancy between the expected rate of return by institutional investors and the cost of shareholders' equity recognized by Japanese companies. One of the main factors is the setting of risk-free rate. In the current negative-rate environment, the risk-free rate Japanese companies recognize is as close to the zero level ; however, there are cases where especially institutional investors with long-term perspective set the risk-free rate relatively higher, when comparing with the current levels of interest rates on the assumption of a steady economic environment. Also, there are cases where global institutional investors set the risk-free rate with the same levels of interest rates as their home countries in mind. The institutional investors in those cases set the risk-free rate to 2–3%, which results in the higher cost of shareholders' equity than that recognized by Japanese companies.

Hence, a company is required to consider the expectation of institutional investors to identify its cost of capital accurately.

## Optimal capital structure policy and cost of capital

WACC is a weighted average of debt cost and cost of shareholders' equity; however, as a prerequisite, the percentages of interest-bearing liabilities and shareholders' equity need to maintain an optimal balance in a capital structure taking into account a company's business risks. Therefore, the company requires a policy for an optimal capital structure (Figure I-8 (5)).

Generally, cost of shareholders' equity is higher than debt cost. Therefore, if a company reserves its shareholders' equity excessively against its business risks, WACC will be in a high level, which requires the company to increase its return. In addition, looking at the current condition of Japanese companies, there are many cases where an excessive amount of cash on hand is recorded on a balance sheet as an account counterpart to retained earnings.

According to the survey by the Life Insurance Association of Japan (LIAJ), 58.9% of the responding Japanese companies considered 'reasonable' for the level of their shareholders' equity, while 69.8% of the responding institutional investors considered 'abundant' ('2017 Approaches toward Enhancing Equity Value' by LIAJ in April 2018). Besides, in the survey, 68.9% of the responding institutional investors answered they received little or almost no explanation on the appropriateness of cash on hand of a company.

In Europe and USA, many companies undertake efforts to decrease the level of shareholders' equity by utilizing interest-bearing liabilities in order to reduce WACC to an optimal point to the extent that the companies do not take excessive risks. It is difficult for a company without a policy for an optimal capital structure to carry out management focused on cost of capital which reflects its business risks properly.

## Capital efficiency indicators and business portfolio

As previously mentioned, (2) setting of targets for profitability and capital efficiency, (3) restructuring of business portfolio, and (4) investment strategies are important for management focused on cost of capital.

Many companies have announced ROE targets in their mid-term business plans since the introduction of the Japan's Corporate Governance Code. Though ROE is an important indicator for shareholders, a lot of business corporations have trouble using ROE in evaluating the performance by business because it is difficult for them to recognize shareholders' equity separately by business unit.

Besides ROE, ROIC and ROA are used as capital efficiency indicators. A company must adopt indicators suitable for its business model in its business management in light of features of each indicator.

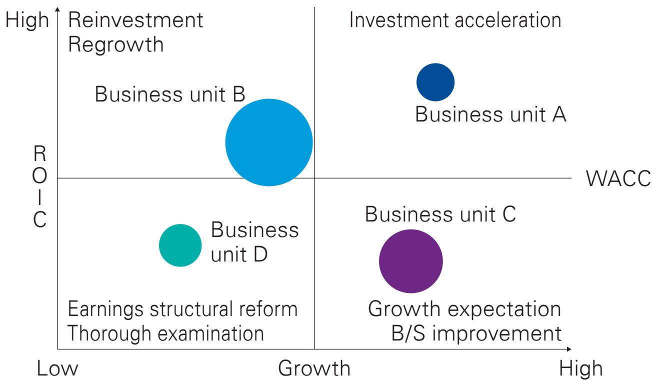
Recently, ROIC has gained attention as an indicator to present earning power. Considering that ROIC is an indicator to calculate return by setting 'interest-bearing liabilities + shareholders' equity' or 'working capital + fixed assets' as invested capital, ROIC has features of ensuring consistency with cost of capital (WACC) and of easy use and comparison by business unit.

Another feature of ROIC is a high affinity with assessment of business portfolio. When examining the restructuring of business portfolio, a company not only considers the unity with the company's management philosophies and business strategies but must have the perspective of whether or not the company can generate return for cost of capital in the mid- and long-term. It is necessary to examine whether or not a business unit with continuous lower return than its cost of capital is included in candidates for portfolio restructuring, even if the business unit stays in the black.

Such examination needs to visualize the positions of business units based on ROIC. This visualization allows a company to manage its business portfolio in a sophisticated manner by restructuring of its business portfolio, taking into account the perspective of return for cost of capital (Figure I-9).

It is also important for a company to examine its investment strategies combined with restructuring of its business portfolio, considering whether investments can generate higher return than cost of capital in the mid- and long-term.

### ■ Figure I-9. Image of business portfolio




*Circles show the size of invested capital.

## Assessment of cross-shareholdings

Regarding cross-shareholdings, the revised Code requires that a company should 'verify the appropriateness of each cross-shareholding by examining concretely whether the purpose of each cross-shareholding is appropriate and whether benefits and risks caused by each cross-shareholding pay for the company's cost of capital' (Figure I-8 (6)). This is a more specific requirement than the former Code which required that a company should 'verify economic benefits in the mid- and long-term and its future prospects'.

Cross-shareholdings are also recorded on a balance sheet, which means they consist of part of a company's invested capital. Investors judge that, if capital invested by a company does not generate higher return than its cost of capital, the appropriateness of maintaining its cross-shareholdings is low.

The assessment method of cross-shareholdings may be different between companies and investors.

In practice, many companies assess their cross-shareholdings by using as the denominator the book value at the time of investment and as the numerator the dividends and profits by transactions and also valuation gain or loss compared with the value at the time of the investment.

There are cases, however, where listing shares are recorded at market values and higher balances than the book values are recorded on a balance sheet. Investors who evaluate performance of companies based on announced financial statements assess their return such as dividends and benefits by using cross-shareholdings based on market values on a balance sheet as the denominator.

It is obvious that a company should verify qualitative factors adequately, and at the same time consider such quantitative evaluation. An essential element of management focused on cost of capital is to generate continuous return as the entire group. It is important for a company to verify the appropriateness of its cross-shareholdings from the perspective of total optimization.

### Awareness of cost of capital in the Board of Directors

Taking into account the aforementioned contents, the Board of Directors is required to always verify how much risk a company should take in terms of its business strategies and whether or not the company can maintain its financial position to bear risks.

If a company can make continuous investments which are expected to generate higher return than its cost of capital and restructure its business portfolio agilely, the possibility of improving its corporate value increases. All of the investments, however, are not made as planned and the restructuring of business portfolio is also a time-consuming effort. From that viewpoint, the company's cost of capital is a hurdle rate for risk-taking as well as a proxy of risk, based on an optimal capital structure to the company in terms of how much downside risk the company can take.

External directors of the Board of Directors play a role to promote the management executives to pay attention to the company's cost of capital. The directors require to promote the company to identify its cost of capital accurately as well as monitor its policy for an optimal capital structure, the management of business portfolio, and investment status. Similarly, in cross-shareholdings, the directors should monitor whether or not a company conducts quantitative and qualitative verification of the appropriateness of its cross-shareholdings adequately from the viewpoint of its cost of capital.

## 2-4 Roles of corporate pension funds as asset owners

The revised Code included a new principle, Principle 2-6 (roles of corporate pension funds as asset owners). The principle requires that, as a plan sponsor, a company takes and discloses measures to help corporate pension funds of the company to play the role expected as an asset owner.

### Purpose of Principle 2-6

Corporate pension funds need to promote secure and efficient asset management for employees so as to build assets steadily and cover living expenses after retirement of the employees. On the other hand, there are many cases of the shortfall in human resources engaged in management of pension funds, and corporate pension funds accept the Stewardship Code to a limited extent.

Even if corporate pension funds have difficulty accepting the Stewardship Code, the funds are expected to conduct stewardship activities, such as monitor the activity status of asset managers of corporate pension funds, in order to promote both the Corporate Governance Code and the Stewardship Code and create a virtuous cycle of the investment chain.

The purpose of Principle 2-6 is that a plan sponsor grasps the reality of its corporate pension funds and supports the achievement of stewardship activities so as to promote the funds to fulfill the functions expected as an asset owner.

## Efforts in human resources and operation

Corporate pension funds are expected to conduct efforts in human resources and operation to carry out stewardship activities such as monitoring of asset managers. The revised Code exemplifies 'appointment and allocation of qualified personnel to asset management'. In other words, corporate pension funds are expected to train and allocate personnel with knowledge and experience so as to conduct stewardship activities as asset owners. Concrete measures include maintenance of a system for asset management by establishing an investment committee and enhancing its functions, improvement of expertise of investment directors/representatives and persons in charge of asset management, and utilization of external experts. In addition, as listed companies, corporate pension funds are expected to disclose the details of the efforts to stakeholders such as institutional investors and employees on their corporate governance report and so forth.

In the current situation where it is difficult for corporate pension funds to promote those efforts independently, plan sponsors need to lead or support them depending on the situation of each corporate pension fund. The operation of corporate pension funds, however, requires independence from plan sponsors. For example, if a director of a plan sponsor is deeply involved in operation of a pension fund, the plan sponsor needs to pay attention to conflict of interest since the director appeals the investment in shares of his/her company, as well as select an asset manager who considers the company as an investee companies.

## Management of conflict of interests

Under the assumption that the operation of corporate pension funds is independent of its plan sponsor, Principle 2-6 requires that conflict of interests which could arise between pension fund beneficiaries and companies are appropriately managed.

It is understood that business owners and executive directors of corporate pension funds have the fiduciary duty for pension funds. By contrast, beneficiaries may have concerns for fiduciaries with opportunities to prioritize their interests that they do not consider the interests of beneficiaries as a top priority (Figure I-10).

In terms of operation of and support for corporate pension funds by plan sponsors, they need to clarify cases of concerns over conflict of interests with beneficiaries, that is, concrete cases which may fall under 'self-interest or interest of third parties', and explain decision-making by corporate pension funds reasonably in order to manage conflict of interest.

■ Figure I-10. Conflict of interests which could arise between beneficiaries and plan sponsors, and responses

| Cases which could cause conflict of interests | Possible responses |
|---|---|
| Proxy voting in case investee companies include shares of a company which has interests in a plan sponsor | • Removal of the scope for intervention by a plan sponsor by leaving the judgment of proxy voting to the discretion of an asset manager<br>• Request for formulating and announcing policies related to the management of conflict of interests in an asset manager |
| Selection of an asset manager considering only capital relationships or business relationships with financial institutions in a plan sponsor | • Establishment of an objective selection process of an asset manager<br>• Disclosure of selection/evaluation criteria and evaluation results of asset managers and management products<br>• Establishment of a structure to reflect employees' interests |

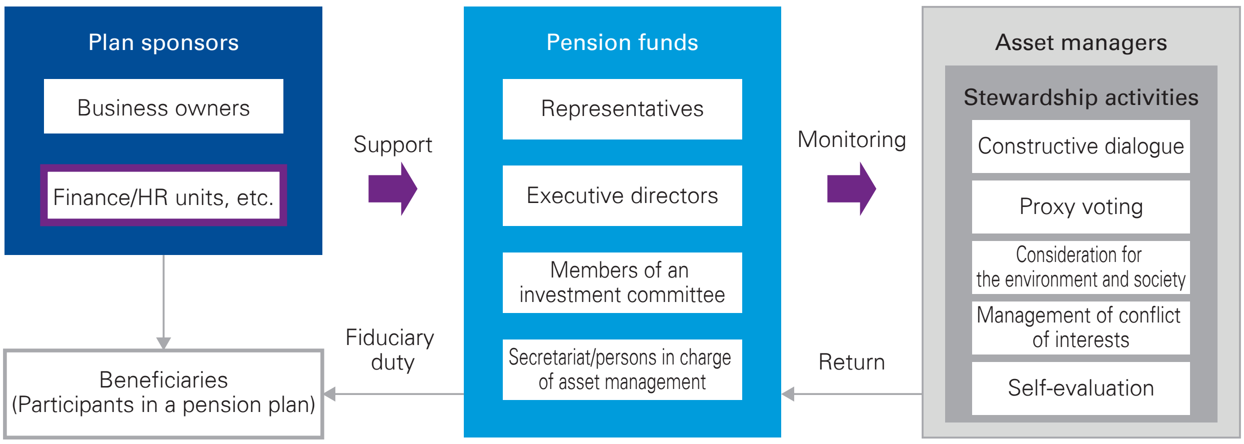
## Roles of external directors to fulfill the role as an asset owner

A virtuous cycle of the investment chain is created so that corporate pension funds can fulfill the fiduciary duty for beneficiaries, such as participants in a pension plan, through return caused by sustainable growth of investment entities, if corporate pension funds can monitor stewardship activities of asset managers effectively as an asset owner (FigureI-11).

Establishment of the virtuous cycle requires a plan sponsor to conduct appropriate measures, such as grasp the actual status of corporate pension funds and subjectively support them.

In order for a plan sponsor to understand the actual status of its corporate pension funds and provide them with subjective support, the roles of external directors of the sponsor are important. The external directors must monitor not only the support status of the plan sponsor but also whether conflict of interests is adequately managed in the operation of corporate pension funds or not. The support by the plan sponsor, including external directors, is expected to allow its corporate pension funds to play the role of an asset owner.

■ Figure I-11. Establishment of a virtuous cycle through 'support' by a plan sponsor



I.

# Column — Status of companies on items of the revised Code observed from Corporate Governance Report

**This column discusses KPMG's survey results of corporate governance reports by Japanese companies (as of 30 September 2018) on their status and measures taken in response to the revised Code.**

## Status of companies' response to the revised Code observed from corporate governance reports

KPMG conducted a survey on the latest reports of corporate governance of each company as of 30 September 2018 (hereinafter referred to as the 'Governance Report(s)'). The results of the survey show that about 2,500 of the surveyed companies updated their Governance Reports after the revised Code was applied and the figure is equivalent to about 70% of listed companies. There is, however, no rule which requires companies to specify which Corporate Governance Code they apply when updating their Governance Reports, the former one or the revised one. Therefore, only about 10 companies specified on their Governance Report that they followed the revised Code.

In these conditions, about 100 companies disclosed the status of their measures to help corporate pension funds to fulfill their role described in Principle 2-6, a new principle in the revised Code. Therefore, in practice, there are a few more companies which respond to the revised Code.

## Disclosure trend seen from corporate governance reports

The following sections discuss the disclosure trend of Japanese companies, including measures taken beforehand for main items of the revised Code which were described in Governance Reports of the companies as of the end of September 2018.

## Disclosure of policies/procedures for dismissal of the CEO

**Disclosure on Governance Reports**

- About 240 companies specified 'dismissal' relating to Principle 3-1.
- Many companies just revised the title from 'appointment' to 'appointment/dismissal'.
- Few companies disclosed the criteria etc. of 'dismissal'.

There were companies which mentioned dismissal as well as appointment of their CEO; however, many of them described mainly the procedures to examine the dismissal of their CEO, while no companies specified concrete criteria or index for the dismissal.

On the other hand, the measures taken beforehand included cases where companies deliberated the necessity of bringing up the dismissal of their CEO for discussion in the Board of Directors, based on periodical evaluation of the matter from the quantitative aspect of performance targets and so forth. In addition, some cases showed that companies considered the performance of candidates for the CEO as well as the achievements of performance targets of the CEO. These companies are thought to consider the practical condition where companies not only dismiss the incumbent but must examine the appointment of a successor after the dismissal, which is assumed to be of some help for the companies which will proceed with their examination on a succession plan.

## Formulation/operation and supervision of a succession plan

**Disclosure on Governance Reports**

- About 340 companies specify 'a successor'.
- Many companies disclosed a succession plan as a reason (an explanation) that they do not conduct each principle.

There were a lot of cases where companies recognized a succession plan as an important matter and started their examination, even though they did not implement the plan at that time.

Cases where companies drew up and started operation of a succession plan included some companies where nomination/compensation committees deliberated candidates considering the examination by a third party, in addition to internal data when selecting candidates. They also included companies which specify the way the management executive should be in detail and train/select candidates in a neutral manner by sharing evaluation/training indexes. In those companies, selection of a successor is not a matter to be approved exclusively by the current management executives, but the Board of Directors is involved in formulating and operating a succession plan subjectively. Looking at these situations, it is obvious that the companies are aware of objectivity and transparency.

## Ensuring diversity in the Board members

**Disclosure on Governance Report**

- About 40 companies described 'gender' or 'international background'.
- Many companies specified their agreement to diversity and the current number of female and foreign directors, and then described the insufficiency was a challenge to be addressed in the future.

There were no cases where the target number or ratio of female/foreign directors were specifically set to ensure the diversity of the Board of Directors.

By contrast, in the measures taken beforehand, some companies clearly stated that they would promote diversity activities as 'a fundamental philosophy' in the idea that diversity was the engine for growth. Also, other companies contained concrete measures considering diversity in career and skills, such as preparation of 'career/skills matrix' for candidates for directors, such as their experienced industry sectors, main management experience, areas of specialty and so forth. Many companies recognize the diversity of the Board of Directors as a challenge to be addressed. Therefore, those measures will be useful for the companies which will proceed with their examination on the diversity.

## Disclosure of policies for cross-shareholdings reduction

Disclosure on Governance Report

- About 30 companies used the word 'reduction' for cross-shareholdings.
- Many companies have a basic policy to reduce only cross-shareholdings without a rationale.
- Many companies did not describe concrete reasons to make exceptions from reduction, such as strengthening of business relationship.

A certain number of companies were aware of capital efficiency in terms of a policy for reduction of their cross-shareholdings. Though these companies used the expression 'cost of capital' in their Reports, there were no cases where specific calculation methods or figures were clearly stated.

Meanwhile, there were cases where companies explained the achievement of 'reduction' of their cross-shareholdings by showing the number of holdings compared with that of the preceding period, and where companies specified concrete quantitative threshold as the verification criteria for economic benefits. More and more companies have been explaining the achievement of 'reduction' of their cross-shareholdings along the revised Code or explaining specific calculation methods of reduction in consideration of capital efficiency, which is the main theme.

## Measures for corporate pension funds to fulfill their role

Disclosure on Governance Report

- About 100 companies disclosed items described in Principle 2-6.
- Many companies provided simple descriptions such as 'allocation of persons responsible for corporate pension funds to prevent conflict of interest' or 'enhancement of knowledge by taking part in external trainings'.

Companies which have accepted the Stewardship Code, including financial institutions, provided adequate descriptions, such as the status where companies utilized a systematic management structure or asset management committees consisted of external experts, or responses according to the guidelines of the Ministry of Health, Labor and Welfare.

At the same time, in the plan sponsors of which corporate pension funds have not accepted the Steward Code, there were cases where plan sponsors obtained advice from neutral and independent external consulting firms. Furthermore, there were cases where they selected investee companies by obtaining evaluation by external consulting firms to prevent conflict of interests. Regardless of the acceptance of the Stewardship Code, companies have started to respond to the revised Code such as working on utilization of external experts depending on the situation of a company, taking into account the system and scale of each corporate pension fund.

## Enhanced disclosure including the intent of the revised Code

Listed companies are required to submit a Governance Report based on the revised Code by the end of December 2018. Companies are expected not to continue to comply or explain formally, but to progress with effective measures and enhanced disclosure including the intent of the revised Code.

# II.

# Current Status and Issues of the Corporate Governance Reforms Viewed by External Directors

The "Second Phase" of the corporate governance reform, encourage Japanese companies to enhance effectiveness of their corporate governance and strengthen the efforts to improve their corporate value over medium to long terms. It is expected that external directors will be required to play more important roles as companies carry out the reforms.
In the previous chapter, we picked up the following four points and discussed actions that companies should take respectively: (1) Ensuring diversity in the Board members, (2) Strengthening procedures for CEO appointment/dismissal and for determination of compensation and utilizing independent nomination/compensation committees, (3) Bringing focus on cost of capital within management and (4) Initiatives to promote a role of a plan sponsor as the asset owner of the corporate pension funds.
In this chapter, we discuss opinions of external directors on the issues related to various points raised in the revised Code, based on the results of the awareness survey with external directors conducted by KPMG.

## 1. Ensuring diversity in the Board members

### Survey result summary

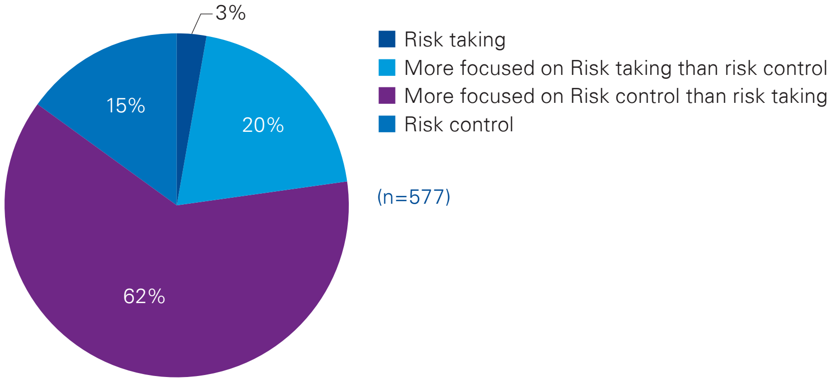
External directors assume they are expected to have an ability to identify and understand potential risks, so that they can help the company achieve sustainable growth and improve corporate value over medium to long terms. Also, respondents assume that companies need external directors with management experience and expert insights, and diversity of Board members to achieve the said goals. As for risk taking, many external directors find issues in development of long-term visions.

### Viewpoint prioritized by external directors in fulfilling their job responsibilities

The survey result shows about 80% of the external directors find it more important to have a viewpoint of risk control than risk taking in fulfilling their job responsibilities (Figure II-1).

■ Figure II-1. Priority of external directors in fulfilling their job responsibilities

Q. In fulfilling your job responsibilities as an external director, which viewpoint do you prioritize, risk taking or risk control?



## External directors' priority from the viewpoint of risk taking and risk control

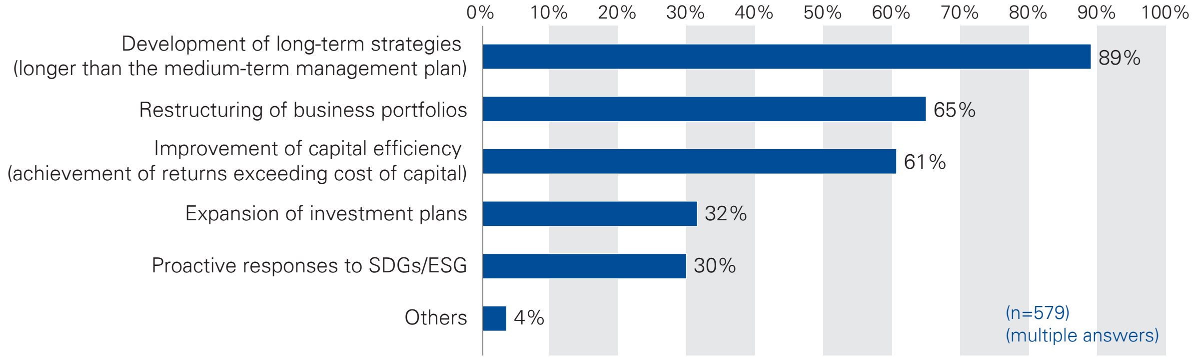
From the viewpoint of risk taking, 89% of the external directors place importance on 'development of long-term strategies (longer than the medium-term management plan)'. In Japan, many companies are developing their medium-term management plans. However, it is said that the number of companies that develop visions for longer terms and execute management strategies based on such visions are still limited. We can infer that external directors are placing importance on enhancing efforts for 'restructuring of business portfolios' (65%) and 'improvement of capital efficiency' (61%) based on such long-term visions (Figure II-2).

As for the viewpoint of risk control, the result indicates that external directors view 'prevention of scandals from occurring' as the most important issue, which was followed by 'improved accuracy of investment risk assessment', 'enhancement of subsidiaries' governance' and 'maintenance of financial soundness'.

Considering the increasing number of M&A initiatives carried out by Japanese companies, including those involving overseas entities, we can infer that external directors are viewing risk assessment of invested companies before the investment and enhancement of governance after acquisition as important risks in corporate management (Figure II-3).

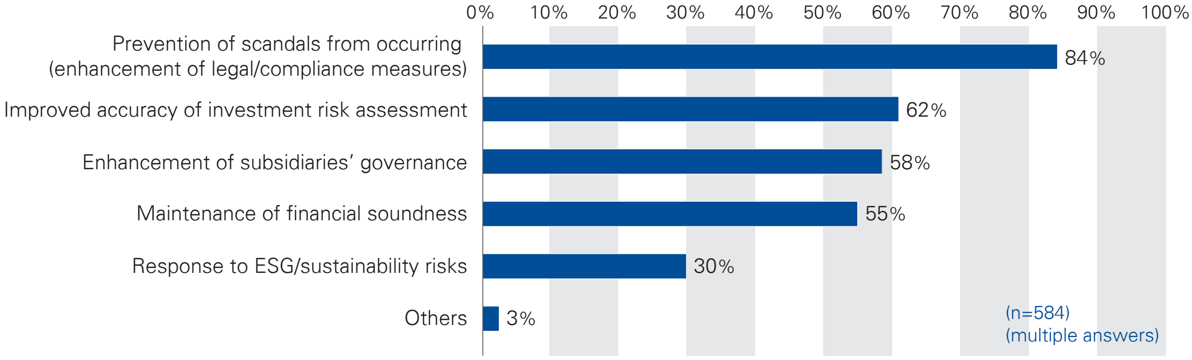
### ■ Figure II-2. Matters that external directors believe to be important from the risk-taking viewpoint

Q. Please select three options that you believe to be important as an external director from the risk-taking viewpoint.




### ■ Figure II-3. Matters that external directors believe to be important from the risk-control viewpoint

Q. Please select three options that you believe to be important as an external director from the risk-control viewpoint.



## Qualities and abilities of external directors

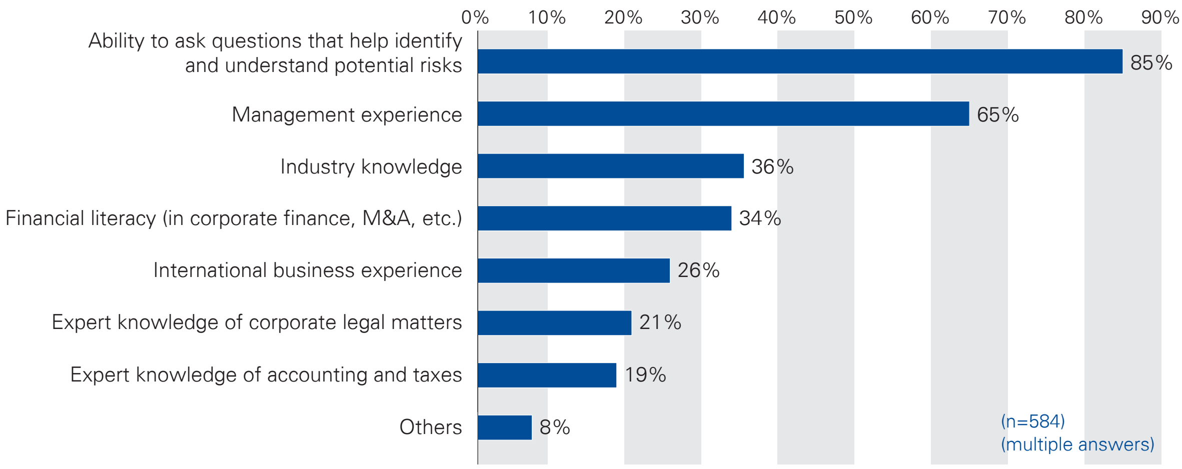
A large number of external directors answered that the ability they are especially required to have was an 'ability to ask questions that help identify and understand potential risks'. As shown in Figure II-5, the external directors find it necessary to have people with management experience and expert insights. This also seems to be reflecting the necessity for them to appropriately identify and understand various types of risks surrounding the company (Figure II-4).

## Composition of external directors

While certain number of respondents answered that the shares of 'female members' and 'global talents (non-Japanese)' should be larger for ensuring diversity in the Board members, the personnel the external directors regarded as the most important were people with 'management experience'. At the same time, many external directors placed importance on 'people with expert insights'. These results indicate that external directors find it more important to have work experience as corporate managers or experts rather than to meet personnel requirements as formalities (Figure II-5).

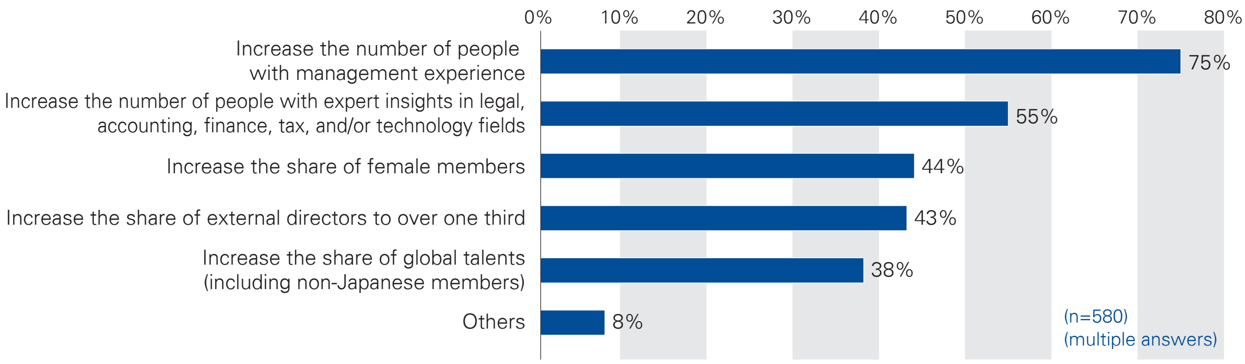
■ Figure II-4. Qualities and abilities especially required for external directors to perform their daily operation

Q. Please select three options that represent qualities and abilities you believe to be especially required for external directors to perform their daily operations from the below.




■ Figure II-5. Matters that should be improved regarding the composition of the external directors in the Board

Q. Please select three options that represent the matters that you believe should be improved regarding the composition of the external directors in the Board.



## Tenure of external directors and maximum number of companies concurrently served

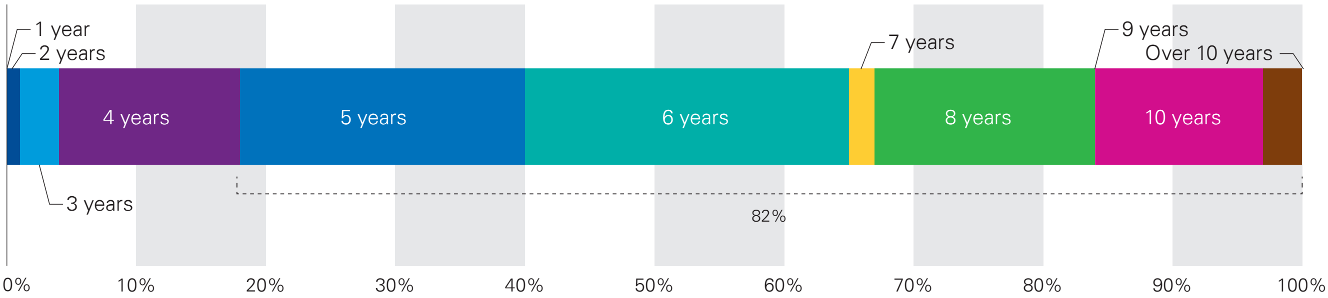
More than 80% of the external directors answered that the appropriate tenure would be five years or longer. This is more than the average tenure of external directors, which is four years (source: 'Future Discussion Issues for Achievement of Effective Corporate Governance', CGS Study Group, Ministry of Economy, Trade and Industry, 18 May 2018). Many external directors find it appropriate to serve for a longer term than the current average term.

While the appropriate tenure would be different among individual companies considering the level of acquisition of the company knowledge and independence issues, many external directors believe that their tenure should be longer than the current one (Figure II-6).

The Corporate Governance Code states that external directors should limit the positions they assume concurrently to a reasonable number to ensure sufficient time and effort required to fulfill their roles and responsibilities as directors. While only about 10% of external directors of companies listed on the first section of the Tokyo Stock Exchange are currently assuming the external director's position at multiple companies (source: research by KPMG), some external directors are providing services concurrently to a large number of companies. In this awareness survey, more than 90% of the respondents answered that the number should be three or less. Therefore, majority of external directors believed that they should not assume positions at four or more companies at the same time (Figure II-7).

### ■ Figure II-6. Tenure of an external director at one company assumed to be appropriate

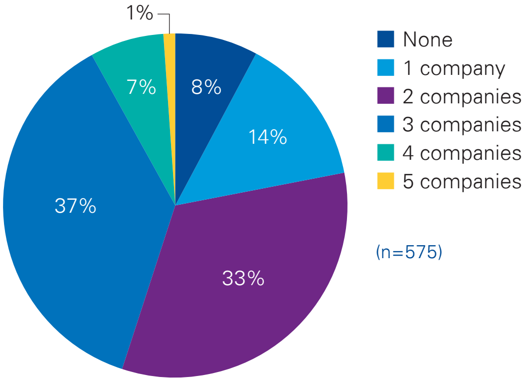
Q. Please select an option, representing the tenure of an external director at one company, you believe to be appropriate.




(n=577)

### ■ Figure II-7. Maximum additional number of companies an external director may serve concurrently

Q. Please specify additional number of companies at which an external director assumes the position you believe to be appropriate.



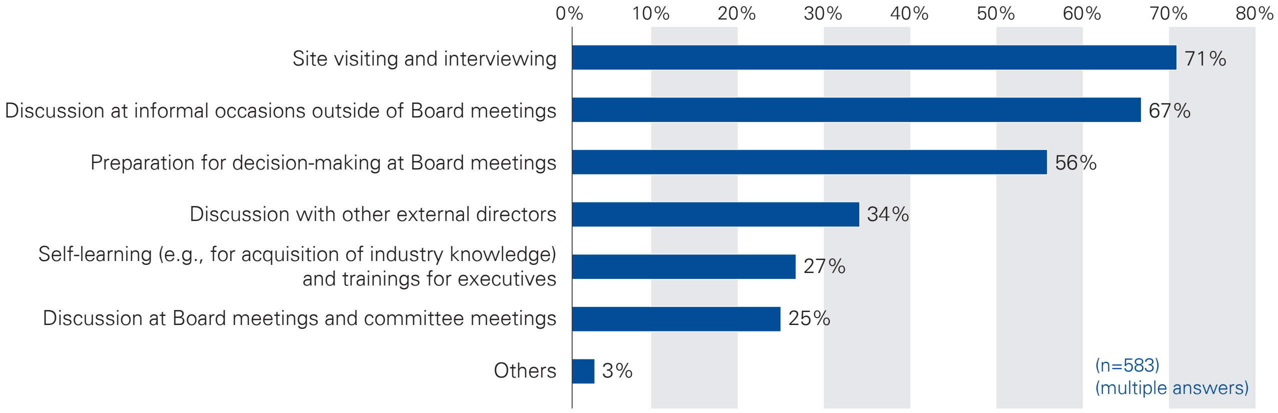

(n=575)

## Tasks on which more time should be spent

Many external directors answered that they should spend more time on 'site visiting and interviewing' and 'discussion at informal occasions outside of Board meetings'. This indicates that many external directors believe that they need to spend more time to increase their understanding of the company's business in order to be prepared for decision making (Figure II-8).

### ■ Figure II-8. Tasks of external directors on which more time should be spent

Q. Please select three tasks on which you believe you should spend more time to fulfill your responsibility as an external director.



## 2. Strengthening procedures for CEO appointment/dismissal and for determination of compensation and utilizing independent nomination/compensation committees

### Survey result summary

Regarding appointment/dismissal of and succession planning for the CEO, the external directors find it important to define the processes clearly. Though the revised Code explicitly requires companies to establish and utilize optional independent advisory committees, not many external directors are paying attention on this.

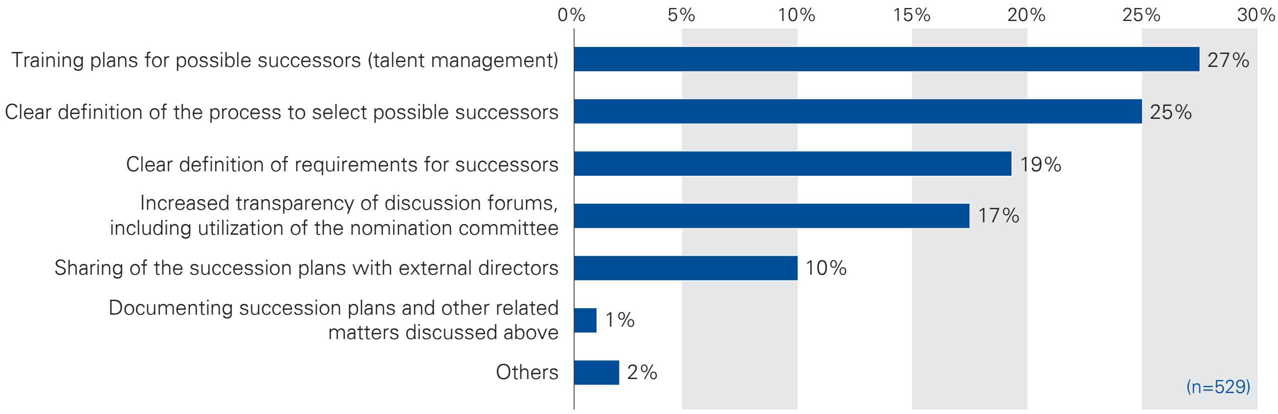
### Issues found by external directors regarding succession planning and dismissal process

As for succession planning for the CEO and other top executives, the survey result shows that many external directors regard 'training plans for possible successors' (talent management) as the largest issue. The revised Code treats succession planning as a broad concept covering not only selection of but also training plans for possible successors. Similarly, external directors view succession planning as an issue. On the other hand, many external directors selected 'clear definition of the process to select possible successors' as an issue. The percentage of external directors who selected the option 'increased transparency of discussion forums, including utilization of the nomination committee' was only 17% (Figure II-9).

As for dismissal of Board members, the external directors find the following as issues: 'clear definition of the dismissal process, including formulation of the criteria'; and 'increased transparency of discussion forum, including utilization of the nomination committee' (Figure II-10).

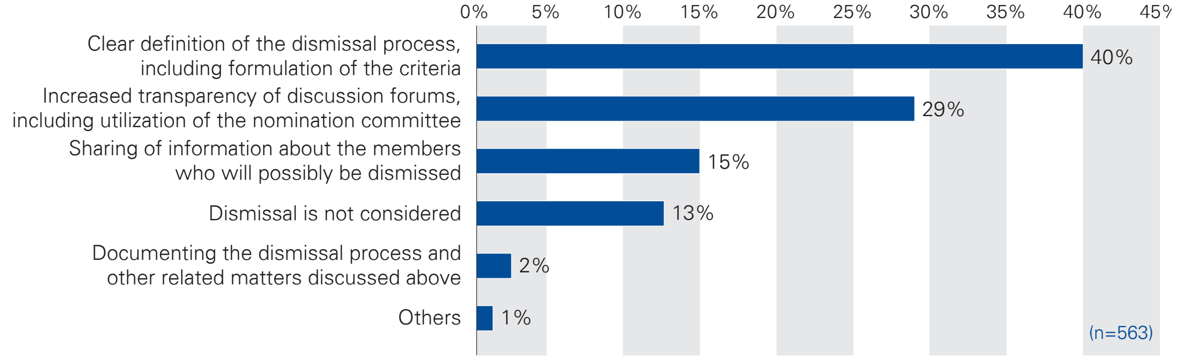
■ Figure II-9. Largest issue external directors find regarding succession planning for top executives

Q. Please select one option that represents the largest issue you find as an external director regarding succession planning for top executives.




■ Figure II-10. Largest issues external directors find regarding the process for dismissal of Board members

Q. Please select one option that represents the largest issue you find as an external director regarding the process for dismissal of Board members.



Currently, slightly over 30% of the companies listed on the first and second sections of the Tokyo Stock Exchange have committees on nomination and remuneration (calculated by KPMG using 'Corporate Governance Information Service' of the Tokyo Stock Exchange). As companies make progress in defining their procedures for dismissal of Board members, it is expected that even more companies will utilize optional nomination committees.

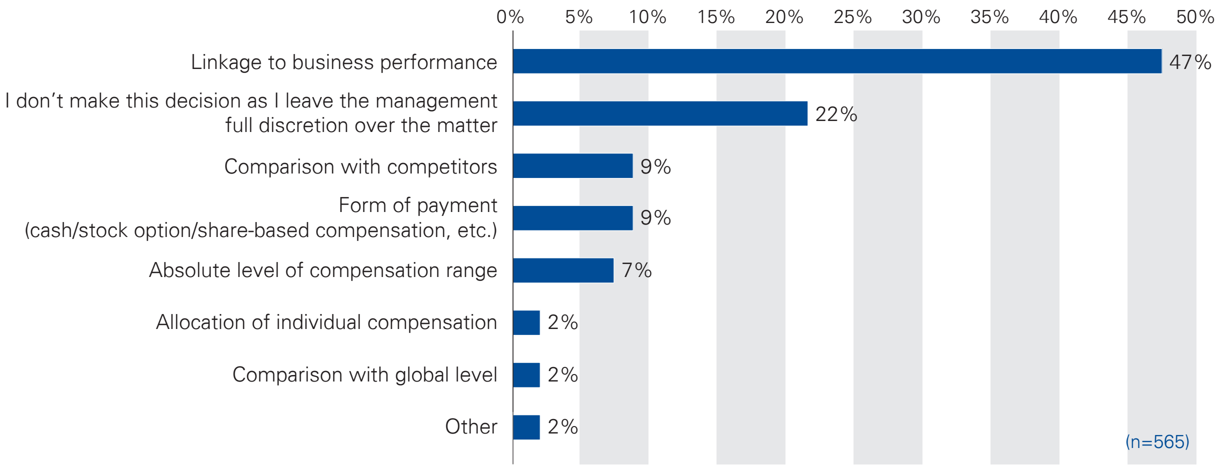
## Key factors in determination of compensation amounts

The figure II-11 clearly shows that for external directors, the most important factor in determination of compensation amount for the management and the directors is the 'linkage to business performance'.

Meanwhile, there were also some independent external directors who selected 'I do not make this decision as I leave the management full discretion over the matter'. As the revised code requires objectivity and transparency in the procedure for determining the management's compensation, external directors are also expected to be more actively involved in the decision-making process of the management's compensation amount (Figure II-11).

### ■ Figure II-11. The most important factor in determination of compensation amounts of the management and directors, as an external director

Q. Select one item that you, as an external director, consider to be most important in determination of compensation amounts of the management and directors.



## 3. Bringing focus on cost of capital within management

### The summary of survey results

Since companies do not calculate their own cost of capital, there is a possibility that the external directors are not able to fully expressing their opinions with an awareness of the companies' cost of capital. As for cross-shareholdings, before carrying out quantitative examination, external directors feel that it is urgent to clarify the purpose/policy of cross-shareholdings in the first place.

### Recognizing the cost of capital

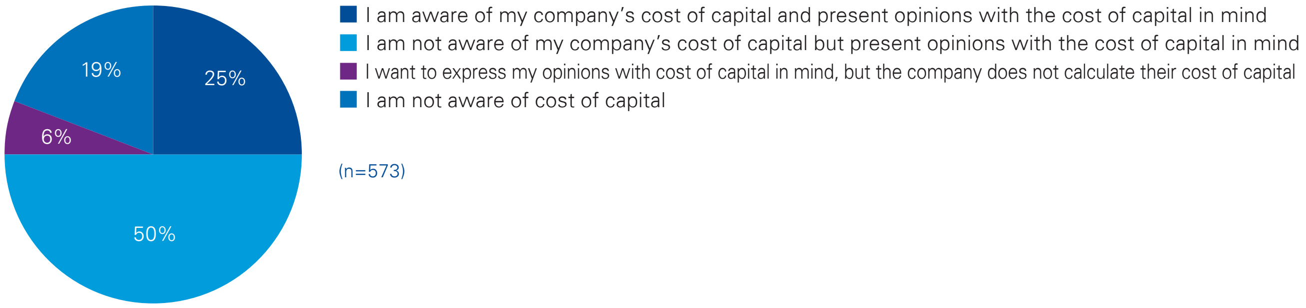
Almost 80% of independent external directors 'express their opinions with the cost of capital in mind' at the Board of Directors' meetings. In comparison, external directors who are 'aware of one's company's cost of capital and keep it in mind when speaking in the meetings' stand at only 25%, suggesting that there still is only a small number of external directors who are involved in the management decision-making process with awareness of their own cost of capital. The revised Code stipulates companies to be aware of their cost of capital in the development of their management strategy. Being aware of their own cost of capital is perhaps an urgent necessity for every company (Figure II-12).

### Reduction of cross-shareholdings

We notice that the most important issue considered by external directors is 'defining the purpose/policies of cross-shareholdings'. The revised Code goes a step further and requires companies to examine the purpose of 'individual' cross-shareholdings from the quantitative perspective in light of their benefits and capital efficiency. In spite of this fact, the survey reveals that many independent external directors consider 'defining of the purpose/policies of cross-shareholdings' more pressing than the quantitative examination (Figure II-13).

■ Figure II-12. External directors' awareness of the cost of capital and opinion exchanges in the Board of Directors' meeting

Q. As an external director, please share information related to your awareness of the cost of capital and opinion exchanges in the Board of Directors' meeting.




■ Figure II-13. The item considered as the largest issue by external directors in reducing cross-shareholdings

Q. As an external director, select one item you consider to be the largest issue in reducing cross-shareholdings.

## 4. Playing the role as an asset owner

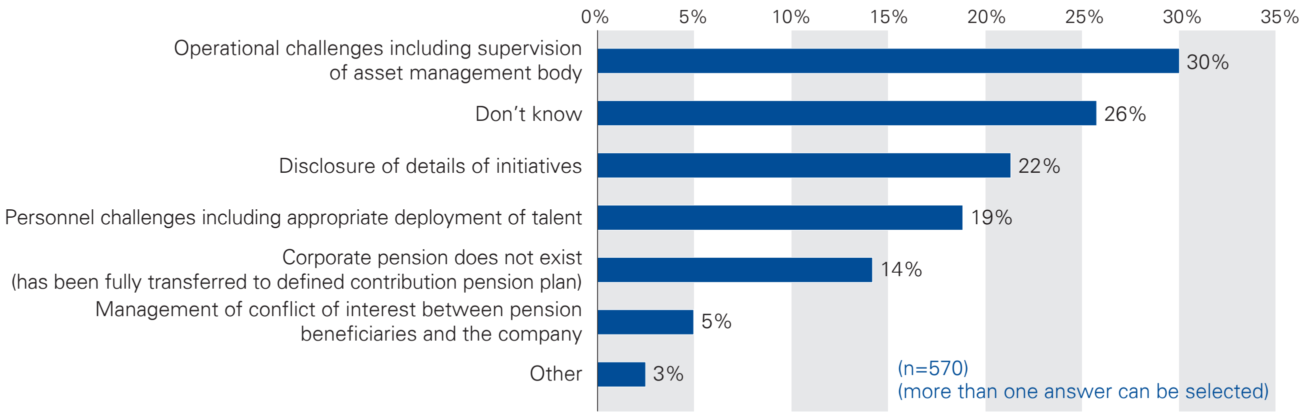
### The summary of survey results

Although the plan sponsor is primarily responsible for proactive monitoring of the corporate pension funds, the survey found that many external directors were not aware of the status of their own corporate pension funds in the first place.

With respect to performing the role of an asset owner, while some directors indicated 'operating practice such as supervision of operating body' as an issue, many others responded that they 'do not know about it'. A number of directors were found to be unaware of the stewardship responsibility of the corporate pension funds in the first place. It is urgent for directors to get an accurate picture of the status of their companies' corporate pension funds at the Board of Directors' meeting (Figure II-14).

### ■ Figure II-14. Future issues related to the corporate pension funds that my company (in which I assume a director position) must overcome in fulfilling the stewardship function

Q. According to you, what could be the challenge in future for the pension funds of the company, for which you serve as an external director, to fulfill their stewardship responsibility?



# Reference: other matters in questionnaires

## Influence of external directors on Boards

Of the external directors, 61% believed that their opinions were 'fully understood and applied to and used in decision-making or supervision'.

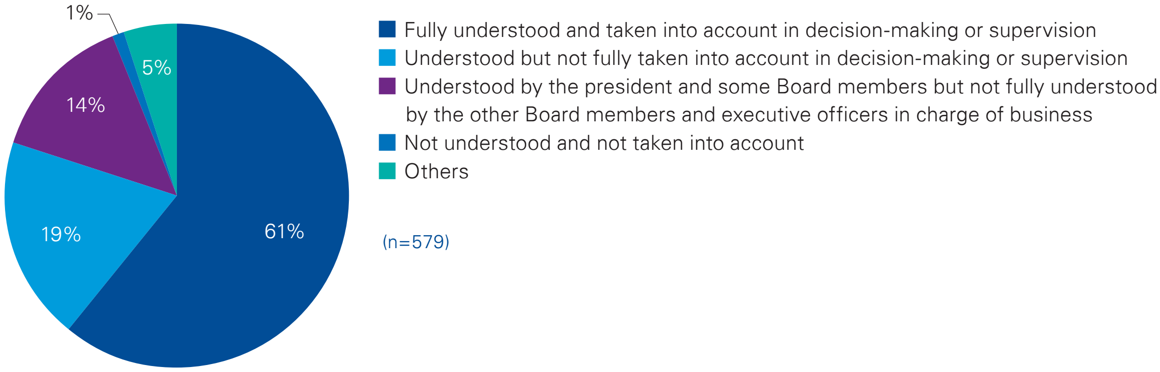
'Others' includes comments such as 'executive directors have strong influential opinions; as for external directors, companies are only concerned about filling the necessary number of their post', 'the posts of external directors tend to be pro forma', and 'utilization of external directors depends on decisions made by the top management', meaning that some external directors have different beliefs from the general consensus about utilization of external directors in companies (Figure II-15).

## The routes of becoming an external director

More than 60% of external directors were invited as external director because they were 'requested directly by companies'. External directors who were 'introduced by professional consultants' or 'introduced by NPOs or groups promoting corporate governance' accounted for only 6%, meaning that most of the external directors were invited due to some sort of a personal connection. This indicates that many companies still do not have various channels for inviting external directors (Figure II-16).

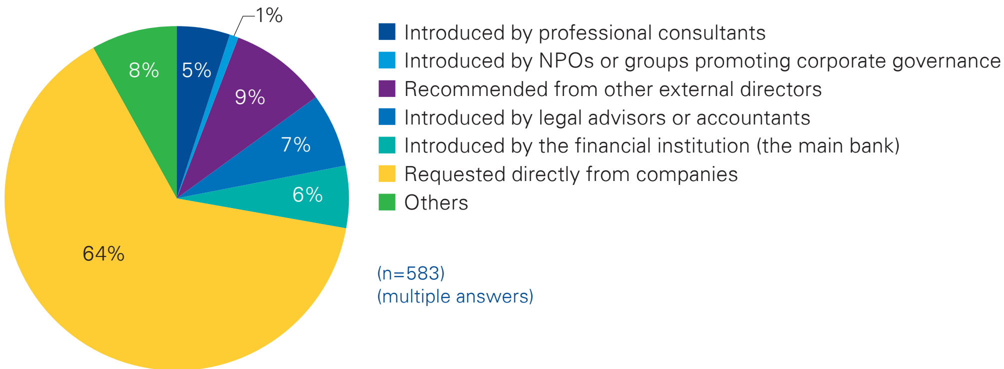
■ Figure II-15. Extent of influence of external directors' opinions on the Board's decision-making and supervision

Q. Do you feel that your opinion as an external director is taken into account in decision-making or supervision?




■ Figure II-16. Routes through which you were invited as external director

Q. Tell us about the routes through which you were invited as external director.



## Items emphasized on assuming office

Many external directors emphasize on 'utilization of their experience and professional skills'. This means that upon accepting the post of external director, they emphasize on contributing to the company by leveraging their experience and professional skills (Figure II-17).

## Building and expanding the human resources market of external directors

For building and expanding the human resources market of external directors, both 'building networks among external directors' and 'positively promoting human resources with professional skills' are considered as most beneficial options, both at almost the same level. External directors expect that building networks including information sharing leads to vitalization of human resources market.

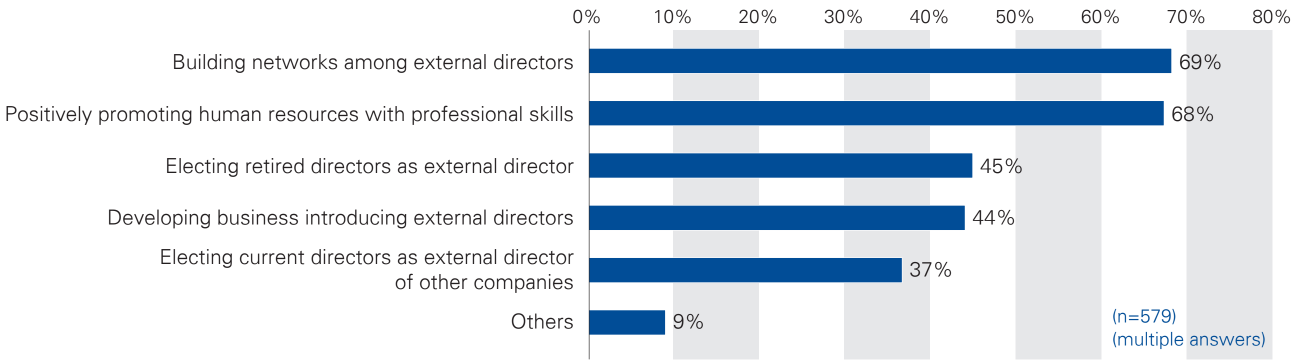
Moreover, a moderate number of external directors selected 'electing retired directors as external director' and/or 'electing current directors as external directors of other companies', believing that it is beneficial to utilize human resources who possess management experience (Figure II-18).

■ Figure II-17. Items emphasized on accepting the post of external director

Q. Which of the following items do you emphasize on when accepting the post of external director?


■ Figure II-18. Beneficial matters on building and expanding human resources market of external directors

Q. Select three items that are beneficial for building and expanding human resources market of external directors from the following.



## Attribution of Board chairperson

Currently, at listed companies in Japan, the president or chairman with the right of representation chairs the Board in more than 90% of the cases; for external directors, the figure is about 1% (compiled by KPMG Japan's 'Corporate Governance Survey 2017') On the other hand, in the US and the UK, a director other than the CEO chairs the Board in 50% and almost all of the companies, respectively. According to the awareness survey for external directors, 10% of the respondents said that an external director should chair the Board, while 74% of the respondents preferred an internal director for chairing the Board. While there is a view that it is desirable that a person other than an executive officer chair the Board in companies aiming at adopting the Board monitoring model, the result of the questionnaire shows that many external directors believe that it is desirable to follow the current practice.

On the other hand, 16% of the respondents selected 'should not decide who is desirable', indicating that they believe that each company should judge by taking into account its own particular situation (Figure II-19).

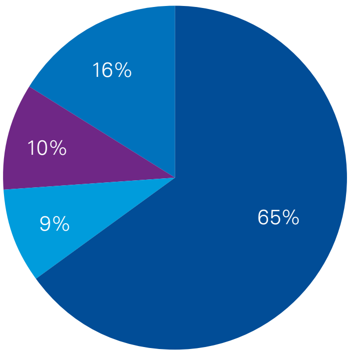
## Dialogue with shareholders and investors

On the subject of holding dialogue as external director directly with shareholders and investors, only 15% of the external directors selected 'should actively hold dialogue with individuals because it is good opportunity for sharing awareness of issues directly with shareholders and investors'. Supplementary Principle 5.1 of Corporate Governance Code requires that directors including external directors and the management positively hold dialogue (interview) with shareholders to a reasonable extent, but in the present situation, a few external directors believe that they should hold direct dialogue.

However, 33% of the external directors believe that they should hold dialogue in the future on the condition that the system is prepared, indicating that nearly half of the external directors recognize the necessity of dialogue. (Figure II-20)

### ■ Figure II-19. Directors who should serve as Board chairpersons

Q. Whom do you think should chair the Board?

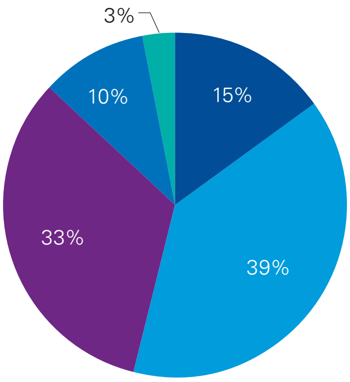



■ Internal directors (the president, chairman, etc.) with the right of representation
■ Internal directors (the chairman, etc.) without the right of representation
■ External directors
■ Should not decide who is desirable

(n=580)

### ■ Figure II-20. External directors' awareness about dialogue with shareholders and investors

Q. Select one applicable item in regard to holding dialogue as external director directly with shareholders and investors.




■ Should actively hold dialogue with individuals because it is good opportunity for sharing awareness of issues directly with shareholders and investors
■ Should not hold dialogue with shareholders and investors individually, but should hold it at IR meetings, etc.
■ Should actively hold dialogue with shareholders and investors in the future, but the company is not ready
■ No meaning of holding dialogue directly with shareholders and investors, and no need for dialogue
■ Others

(n=580)

## Comments obtained from the awareness survey



| Key points of the revised Code | awareness survey items | comments |
|---|---|---|
| 1. Ensuring diversity in the Board members | Risk-taking/risk control (Figure II-1) | I think taking on a challenge and risk-taking for new things are required, and our company takes decent actions. |
| | | The most important action to achieve this goal is to provide support for management's risk control activity. |
| | | The judgment criteria for risk-taking and risk control are: (1) assessment of the kind of a risk present; (2) whether we can avoid or minimize such a risk; and (3) after minimizing the risk, whether we can take the remaining risk. |
| | Key items from a risk-taking perspective (Figure II-2) | Provide necessary comments (advice) for a company's long-term growth as well as behave with an awareness of accountability to long-term shareholders. |
| | | There are a number of borrowings and a high level of market volatility risk due to characteristics of the main business. It is, thus, required to expand and stabilize a subscription business model resulting from the main business for the long term. Also, measures to develop employees over time should be taken. |
| | | I believe that a discussion, without putting too much weight on finance, from a mid- to long-term perspective, and not a short-term, is important. |
| | | I consider how I can engage in mid- to long-term growth of a company and how responsible I would be, or can be, for the result. Without considering these elements, an external director would be a person who repeatedly presents the majority's fair argument just as a bystander. |
| | | Speak and play a role of a person who contributes to mid- to long-term growth of a company. |
| | | Growth strategy and its implementation |
| | | Under the circumstances that the industry should be transformed globally, it is difficult to make an advance investment while looking ahead in the future. Management needs to have the courage to overcome this difficulty and accept the challenge. |
| | | Sharing the long-term management plan |
| | | Provide social value, and create and expand corporate values. |
| | | I think that a challenge for external executives should be whether they can give advice based on management's responsibilities and a long-term perspective. |
| | | External directors should focus on discussion over the key direction of management from a long-term and wide perspective, without speaking or providing comments on matters that can be left to the executives. |
| | | There is not a strong enough culture to welcome discussion in line with economic rationality to enhance corporate values for mid to long term. I am painfully aware that it is necessary to communicate opinions by conversing in a manner acceptable to the executive committee. Considering the social aspects, it seems there is a need for further education to enhance management literacy. |
| | | Within a company's history and corporate culture, there is a mix of good and bad things. When external directors need to identify good or bad things, it is easy for them to provide opinions for which results have already been obtained, but it is very difficult to determine which a mid- to long-term issue is. |
| | | A month has passed since I became an external director. Firstly, I need to understand the mid- to long-term strategy and the management policy of the company. Thereafter, I can identify the possibility and risks of IP creation and business incubation to provide appropriate opinions. |
| | | Do we have a vision for the market environment, and a growth driver in the environment or a new growth driver? |
| | | In addition to risk management and compliance, it is important to have a growth strategy. It is not only protection of a company in an appropriate way but also future growth that will contribute to the investors and society. Stock compensation and stock option are also important for growth motivation. |
| | Roles and required qualities and abilities for external directors (Figure II-4) | In Japan, external directors' authorities, compensation, information and positions are not clarified due to their unclear scopes of responsibilities for the business and management contents. |
| | | Monitoring and advisory are external directors' functions. While extremely high expectations are set for our company's external directors, it would be appreciated if a clear guideline of their functions is provided to show how much they are allowed to be involved in and discriminate from functions of executives. |
| | | There is an opportunity to provide opinions at not only the Board of Directors but also at the management meeting, which involves an executive function, as appropriate. |
| | | External directors must be required to perform a function of 'supervisory on management' because of gaining attention from overseas investors and activist shareholders. On the other hand, management may expect them to continuously perform a function of 'advisory to management'. I will perform my duty as an external director by demonstrating strong professional skills while balancing these functions. |
| | | As an external director, I am in a position to demand executive directors to pursue company's interests as well as supervise if there are any illegal actions performed when pursuing own interests. Sometimes, I can be indecisive in how to perform my duty by balancing these two different positions. |

<table>
<tr><th>Key points of the revised Code</th><th>awareness survey items</th><th>comments</th></tr>
<tr><td rowspan="27">1. Ensuring diversity in the Board members</td><td rowspan="12">Roles and required qualities and abilities of external directors (Figure II-4)</td><td>As a matter of course, external directors must be responsible to speak or behave in an appropriate manner because they do not engage in business execution in principle. In other words, they should not thoughtlessly speak or behave on a whim (external directors should correct themselves right away when using improper words).</td></tr>
<tr><td>External directors should provide their opinions to offer constructive suggestions, and not just criticize executive officers.</td></tr>
<tr><td>Provide emphasis on transparency and openness to the public when providing information (measures for IR or shareholders).</td></tr>
<tr><td>Suggest/propose identification of issues and alternative solutions.</td></tr>
<tr><td>Awareness as a balancer in management</td></tr>
<tr><td>I think roles played by external directors must be different depending on the type of Board a company adopts — 'management Board-type corporate governance' or 'monitoring Board-type corporate governance'. It is not wise to presume the type to be chosen; it should be decided depending on scale of company, how much globalized a company is, its history and industry.</td></tr>
<tr><td>As for a company with a Board of corporate auditors, external directors are required to be involved in decision-making on individual operations. Rationality of the decision-making process when submitting the agenda to the Board of Directors should be a judgment criterion. It is important to understand that roles and responsibilities of external directors vary depending on a company's institutional design.</td></tr>
<tr><td>Aggressively take initiatives against unreasonable decisions.</td></tr>
<tr><td>Monitor execution of activities by internal executive directors and their achievements as well as be aware of issues from a wider perspective while taking into account shareholders' points of view. Seek to speak out on the subject of company's existence at the meetings of Board of Directors and management meeting.</td></tr>
<tr><td>As shown in the Corporate Governance Code, a supervisory function is required to be performed by mainly external directors. On the other hand, issues in governance was recently found in the manufacturing sector (automotive and steel sectors). If no actions have been taken for a long period on management's illegal acts or hidden institutional misconduct, they cannot be excused and external directors are supposed to know about them. I think external directors are required to monitor if there are key issues that are not submitted or reported to the Board of Directors.</td></tr>
<tr><td>It is difficult to present issues recognized by external directors without exception because each company operates in a different situation. Though it depends on the situation, keeping a certain distance from management is necessary because too much involvement in or distance from a management function is not preferable. In general, external directors' duties are to provide advice on management direction at an achievable level while providing feasible and unique suggestions and avoiding following the methods used in the past based on understanding of management environment and issues of the industry. Well-balanced background diversity, specialty and management experience of each director are important to introduce a number of external directors.</td></tr>
<tr><td rowspan="16">Diversity in the Board of Directors (Figure II-5)</td><td>As for women in senior management or management of other companies, due to lack of suitable candidates for external directors, it cannot be helped but to be weighted towards a specialist candidate during such transition period.</td></tr>
<tr><td>I think it is better to think positively about hiring a former executive (a person who resigned/retired at least five years ago) as an external director (or a retired staff of a majority shareholding company).</td></tr>
<tr><td>Currently, most of the external directors are lawyers, accountants or scholars. In the aspect of a company's defense (governance, compliance), this situation is effective. Even so, I think we should appoint more persons with management experience to revitalize a company.</td></tr>
<tr><td>External directors participate in and monitor executive functions, which seems to be essential to improve practical governance.</td></tr>
<tr><td>Due to lack of women candidates for the post of director (including external director position), it cannot be helped but to choose women directors for a certain period of time.</td></tr>
<tr><td>It is better to delegate management functions to directors and executive officers, and external directors should not get too much involved in a company's operation. I do not think it is a good idea to dismiss directors based on academic judgment. Appointment of external directors from academic fields should be deliberated.</td></tr>
<tr><td>It must be noted that a lawyer, accountant, or scholar should not be easily appointed when hiring external directors.</td></tr>
<tr><td>Promoting diversity (in particular, elder employees and women as potential work forces)</td></tr>
<tr><td>In particular, a retired person with CEO experience should work as an external executive of a company, not being appointed as an advisor for the previous company.</td></tr>
<tr><td>Because external directors are not executive officers, a balance between the positions of an external director and an executive officer must be kept (a company must consider a ratio of external directors to total directors).</td></tr>
<tr><td>Corporate governance should be strengthened in a hybrid manner, which is a collaborative creation of knowledge of internal and external executives.</td></tr>
<tr><td>Maintain expertise and independence firmly.</td></tr>
<tr><td>Improve expertise of external directors.</td></tr>
</table>

<table>
<tr><th>Key points of the revised Code</th><th>awareness survey items</th><th>comments</th></tr>
<tr><td rowspan="24">1. Ensuring diversity in the Board members</td><td rowspan="4">Term of office (Figure II-6)</td><td>We should consider changing the term of office of independent directors to four years, the same as the one of corporate auditors.</td></tr>
<tr><td>They should not take responsibility of or propose initiatives for mid- to long-term issues. Many companies replace Board members in about four years.</td></tr>
<tr><td>For a question regarding term of office of independent directors, I chose '10 years' because there was no other option available other than selecting a certain period. I suggest that the term should be decided on a case-by-case basis depending on role expectations for external directors, and not by deciding a specific term like this.</td></tr>
<tr><td>A mandatory retirement system for internal advisors and consultants should be introduced.</td></tr>
<tr><td rowspan="6">Number of companies and time frame for which directors concurrently serve (Figure II-7)</td><td>External directors who serve as part-time directors provide advice based on their experiences and own judgment without fully understanding daily corporate management work. They should point out and discuss matters on which internal directors cannot comment due to their positions.</td></tr>
<tr><td>I think Japanese external directors engage in a company for only a small period of time. I would like to engage for as long as an external director does in the US.</td></tr>
<tr><td>Although it depends on their abilities, still it is difficult for external directors to concurrently work for various companies.</td></tr>
<tr><td>Within a limited time while serving in the Board of Directors, it is highly difficult for external directors to play their roles properly. They should demand opportunities to identify issues during communication with executive officers, or visit sites on their own. In any case, I recognize that it is still a long way from carrying out the corporate governance reforms in a position of an external director.</td></tr>
<tr><td>External directors cannot take much time in comprehending the situation of a company and inspecting sites due to the busy schedule of their main roles and responsibilities.</td></tr>
<tr><td>There is a thin line between the functions of executive officers and external directors and a limit to coercive authority when major corporate changes should take place.</td></tr>
<tr><td rowspan="10">Understanding business and operation status (Figure II-8)</td><td>It is important to have an opportunity to the Board of Directors at key sites in Japan or overseas. It would be a good opportunity for external directors to know the business sites, and at the same time, it would motivate site management and employees.</td></tr>
<tr><td>Importance of understanding a company's business</td></tr>
<tr><td>They do not have to be involved too much in business execution and operation, yet at the same time they should not make a judgment without knowledge and understanding of the business. It is difficult to clarify this balance to some extent.</td></tr>
<tr><td>It is important to take initiatives to understand the situation of individual companies.</td></tr>
<tr><td>External directors are required to present a more objective view than internal directors, but there are matters they cannot make a decision on without being aware of the internal situation. But if they know the internal situation too well, they would make the same decision as internal directors do. How can this inconsistency be solved? I would like you to generate ideas.</td></tr>
<tr><td>Lack of sufficient knowledge on business, products and technology of a company.</td></tr>
<tr><td>While there have been many discussions on checking management's execution results, only a few discussions on management's execution methods and strategies are made. This is because internal executives related to the execution method participate in discussion but there are only a few external directors who know a strategy well.</td></tr>
<tr><td>After being appointed as an external director, I have realized that lack of knowledge of a company is a bottleneck. So, creating an opportunity for continuous communication is important for collaboration with internal directors.</td></tr>
<tr><td>I serve as an external auditor for another company. I do not think many external directors and auditors seem to understand situations of business sites and subsidiaries. As a result, they provide useful advice in general terms but also many opinions unrelated to topics. I know it is not easy to serve as an external director or auditor on a busy schedule. But if they accept the appointment, I believe they should visit sites, even if it is burdensome, and have a dialogue with executives, staff or president at the sites to inspect and understand the actual status.</td></tr>
<tr><td>I understand that situations, where external directors need to deal with, are different depending on each company. I hope that practical results are accumulated by collecting insights on business operations and establishing an environment to use them among external directors.</td></tr>
<tr><td rowspan="6">Communication among executives (Figure II- 8)</td><td>Fully understand a management purpose and be able to contribute to a company, but lack knowledge of sector-specific business.</td></tr>
<tr><td>Provide external directors with an opportunity to increase awareness of and deeply understand a company, business and talents.</td></tr>
<tr><td>Use a horizontal connection and network of external directors.</td></tr>
<tr><td>Need to establish an environment for discussion because there are various answers for decision-making and management judgment.</td></tr>
<tr><td>Aim to increase communication with employees other than directors and auditors.</td></tr>
<tr><td>I think communication with chairman and president and provision of honest advice are the most important factors.</td></tr>
</table>

II.

| Key points of the revised Code | awareness survey items | comments |
|---|---|---|
| 1. Ensuring diversity in the Board members | Communication among executives (Figure II-8) | There is a need of communication between external directors and an audit firm. |
| | | Importance of open discussion |
| | | Due to lack of information on best practices of independent external directors and on performance benchmark, communications are conducted by assuming the right way. We hope to use such information openly (inside and outside external directors' community). |
| | | I think 'communication with employees' is much needed instead of merely taking our own efforts. |
| | | Having an 'opportunity to communicate among executives' including the Board of Directors is important, as it always has been in the past. |
| | | I do not think friendship with management is a problem but we have to be careful not to hesitate to have an open discussion due to a close relationship. |
| | | I think communicating with not only executives but also with employees, as needed (in general terms), is required. |
| | | Opportunities for communication among directors and external directors outside the Board of Directors should be increased. |
| | | It is desirable to have more opportunities for communication among external directors such as external directors and external auditors. |
| | | There is active discussion. Provision of more opinions from executives is preferable. |
| | | Publish information on each company's specific measures for introduction of the CGC and response status to issues in a timely manner, and develop a system to share information. |
| | | Regardless of execution, our issues pertain to how much information and details we can obtain and how we can behave to achieve the results. |
| | | Confirmation of an emergency contact system |
| | | In order to deepen a discussion at the meeting of Board of Directors and other meetings, measures are taken to share information with internal directors. |
| | | To make an appropriate and fair decision, it is desirable to develop an information provision system to share issues and challenges at office. |
| | | Discuss details at the Board meeting, and proceed, examine and report decisions in a timely manner. |
| | | Even though I provide my advice to agenda items at the Board based on my experience and knowledge, I am not sure if I can play my role to meet a company's expectations. In order to play a number of roles, I need further information. |
| | | In order to obtain and share information with a company and provide my opinion, (due to my part-time position), I think I need to have a smooth communication with internal executives (including executive officers) and improve humanity. |
| | | External directors need to obtain necessary information on a timely basis to make an appropriate decision. I think there is still a question of whether they can really do so. A company has to recognize this importance if it really wants to utilize external directors. |
| | | I do not have an opportunity to directly deal with an issue. I would like to improve myself to be reported and prepare consideration of matters other than issues. |
| | | Sometimes agenda items (in particular, items regarding overseas matters) are submitted late, and a vote is held without enough discussion and confirmation. ⇒ leading to increase in financial damage |
| 2. Strengthening procedures for CEO appointment/ dismissal and for determination of compensation and utilization of independent nomination/ compensation committees | Succession planning (Figure II-9) | I believe a major issue is that how much I can be involved in succession plans for top management. |
| | | Systematically develop external directors and preferred talents (under the Japanese HR system with less mobility of human resources, it is difficult to develop talents with wide and general knowledge). |
| | | To develop succession plans, objective views from external directors are required even though companies may be undergoing different circumstances. |
| | | As increase of overseas M&A is anticipated, not only related to legal and financial due diligence but also post-merger integration (PMI) including management, human resources and marketing, which are highly important for risk management. In particular, it is important to note how we can select management and support PMI. |
| | | I am an external director. Succession plans have not been developed and the advisory committee on nomination has not been set up yet. Although globalization, diversity and work style reform are advancing and financial and legal management have been improved, these do not directly contribute to improvement of productivity and corporate value. |

| Key points of the revised Code | awareness survey items | comments |
|---|---|---|
| 2. Strengthening procedures for CEO appointment/ dismissal and for determination of compensation and utilization of independent nomination/ compensation committees | Processes for appointment/dismissal of directors and for determining directors' compensation (Figure II-10) (Figure II-11) | Effectively use abundant cash and deposit; develop succession plans at every level. |
| | | The most practical and important matters are: evaluation and appointment/dismissal of representative directors; design of a directors' compensation system; and discussion and update by focusing on these issues. |
| | | I think that external directors need to continue to be aware of 'their ultimate role to replace CEOs to maintain and develop the organization', regularly understanding CEOs' thoughts and their assumptions, and having constant discussion in order to avoid such situations. |
| | | To decide directors' compensation, there should be a difference between compensations of CEO and other officers. Otherwise, the link between responsibility and compensation may disappear. |
| | | I wonder whether external directors appropriately play their roles as compared with compensations granted to them (it is said that there is a substantial variety of compensations depending on companies). |
| | | At some companies, doubts could arise in unfair factors and neutrality in the appointment process of external directors. |
| | | External directors assume heavy legal responsibilities, but the current compensation levels are not appropriate. Is it better to reduce their responsibilities? Or is it better to raise their compensations? These are tough questions, and I think each company has different answers. |
| Other questionnaire | Management's understanding and attitude toward external directors (Figure II-15) | I do not deny the necessity of determination of a company's policy and measures based on the 'assumption' of a policy and measures provided by senior officers. If so, there is doubt whether we must obey the 'assumption'. I wonder whether external directors who are not senior officers of the company can study and make a judgment of the 'assumption' (it must be impossible). |
| | | A goal of corporate governance is an ideal theory. Having three years of experience as an external director, I have realized from management's toil that external directors' rational thoughts and advice are not understood and sometimes do not fit to Japanese management in a spirit of harmony and cooperation. To implement all, management and external directors need to develop relationships first, which I think will take some time to let the functions work smoothly. |
| | | There is a significant gap between expectations and actual roles of the governance code. As executive directors have influential voices, external directors seem to feel that their role is just to form a quorum. |
| | | Its presence and roles are not clearly shown outside a company. As a result, an appropriate evaluation is not made through proxy voting. |
| | | It is important to take responsibility and roles as external directors to meet expectations of a company that accepts them. Generally, it seems that an external directors system is still just a formality. What kind of external directors does a company want? I would like to know the ideal Board of Directors. |
| | | It should not be a formality. Existence of external directors can be discipline for top management (review themselves). |
| | | While considering shifting to a company with Board of Corporate Auditors from a company with audit and supervisory committee system (due to necessity to have external directors), external directors' function and audit and supervisory committee function are likely to 'just meet an apparent standard'. |
| | | There is no management that tries to listen to external directors yet. |
| | | This must be a required institutional action, but I am concerned that we are focusing on the US style too much. Law school and finance school systems do not work well because of our different social code. The same situation may happen to the corporate governance. It is dangerous to be a copycat of the US business. |
| | | Generally, this is a system introduced based on a management philosophy in the West. Considering its reason for existence and practical form, it might be impossible and nonsense to adopt the system as a golden rule in Japan, where a different social background and employment system exist. Under Japan's lifetime employment system, it is impossible for the recent directors who had spent time in a society with lack of employment mobility to manage the system. But I think the system produces a certain result as legal measures are taken and the number of companies that introduce the system has been increasing for the last ten or twenty years. |
| | | There are still many well-known but figurehead external directors and external directors from an academic field who emphasize on expertise. The compensation system is not always based on the 'pay for performance' concept. Given the current macro environment, external directors who can essentially contribute to 'corporate value = shareholders' value' approach of a company (and who can promote a company's sound risk taking) should be respected and the number of external directors should be increased. |
| | | Use of external directors depends on top management's attitude. |
| | | Top management's recognition of being fully aware of 'last conscientiousness' for a company leads to a basis for business operations. |
| | | The most important thing to increase contribution of external directors is attitude of internal representative directors (top management). |

# About KPMG Japan Corporate Governance Center of Excellence (CoE)

KPMG Japan's Corporate Governance Center of Excellence (CoE) was formed with the aim of studying, analyzing and providing information on corporate governance trends in Japan.

KPMG Japan's Corporate Governance CoE comprises KPMG Japan's experts on the Companies Act, Boards of directors and risk management, financial strategies, dialogue with investors (engagement), integrated reporting, information disclosure and shareholder meetings. The organization compiles knowledge and best practices related to corporate governance by utilizing KPMG's global network and affiliated external institutions, and gives advice.

The Corporate Governance CoE will continue to provide information on the latest trends in corporate governance by holding seminars and issuing reports, among other endeavors.

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