New Corporate Governance Principles

Japan Corporate Governance Forum

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New Corporate Governance Principles

Foreword

A joint stock corporation is an organization established using investment from shareholders, which creates new value by organically combining labor and equipment, together with accumulated technology, capital and credit. The shares issued by a company circulate in the market and the shareholders that own these shares are granted a variety of rights to secure their own economic interests such as claiming distribution of profits and claiming the division of residual assets from the company, while also engaging in management by voting in general shareholders' meetings for the company's interests and achievement of its goals. Directors and executive officers are people who shareholders have entrusted with the duties of maximizing the company's profits, and have not been given control of the company.

However, the current state of affairs in Japan is far from this ideal. Hampered by factors such as cross-holding of shares between companies and insufficient disclosure of information, general shareholders have few opportunities to be involved in management, and it was not even desirable for shareholders to directly hold accountable the directors and executive officers entrusted with management.

This state of affairs in Japan was torn apart by the collapse of the bubble economy, an economic downturn lasting over ten years, the growth of institutional investors such as pension funds and the internationalization of the securities market. The distortions of management that had previously been painted over with high share prices were exposed and numerous companies collapsed or were faced with scandals. Calls from shareholders inside and outside Japan to redefine the shape of management overturned the traditional practice of accepting checks by boards of directors, statutory auditors and accounting auditors to be nothing more than formalities, resulting in frequent occurrences of shareholder derivative litigation, which in turn led to revisions to the Commercial Code being made almost every year. This trend picked up momentum in the 21st century, and hostile takeovers taking control through stock acquisitions and proxy battles fighting for majorities in general shareholders' meetings have become reality.

As a nonprofit academic research group in which businesspeople and academics work hand in hand to conduct the organization's activities, in May 1998, the Japan Corporate Governance Forum previously released the Corporate Governance Principles presenting a model for Japanese companies faced with increasing internationalization. In October 2001, the organiza-

tion drew up the Revised Corporate Governance Principles[*1] based on factors such as a greater understanding of corporate governance, the widespread use of executive officer systems, the establishment of consolidated accounting, and new trends in the revision of the Commercial Code. In order to make the regulation of operating officers effective, emphasis was placed on ensuring the functions of supervisory organizations, and the separation of supervision and execution of operations. This led to the introduction of companies with committees in the 2002 amendment to the Commercial Code, but this philosophy put forward in the 2001 revised principles should continue to be upheld as the premise of corporate governance theory in Japan in the future.

Changes in the five years since the drafting of the revised principles have been far greater than the Forum had expected. In addition to the increase in hostile takeovers mentioned above, quarterly disclosure has been introduced, accountability of audit firms has been clarified, and companies with committees made up principally of outside directors have been recognized due to the revision of the Commercial Code. Furthermore, the Company Law was established to combine relevant legal ordinances such as the Commercial Code, the Limited Liability Company Law and the Law for Special Exceptions to Commercial Code Concerning Audit. In the United States where systems for supervising management have become well-established, irregular accounting was revealed in companies such as Enron and WorldCom, resulting in the enactment of the Sarbanes-Oxley Act incorporating strict regulations on directors and audit firms. Similar movements are also gaining momentum in Europe, with one such example being the revision of the Combined Code in the United Kingdom.

Meanwhile, CSR (corporate social responsibility) that looks out for not only shareholders but also relationships with many stakeholders has been gaining much attention and there is strong demand to arrange this in relation to conventional corporate governance. To begin with, adjustments of interests between various stakeholders is basically left to the market mechanism, but steps from a CSR perspective are essential for problems such as environmental issues in which the market mechanism is not applicable. Furthermore, defense measures (poison pills, etc.) used by boards of directors against hostile takeovers have become widely known. It has become less common to view joint stock corporations as single entities, and viewing companies in group units has become established not only with regard to accounting but management in general. It can also be said that there is a deeper awareness of the importance of internal control.

One point that should be noted here is that the Company Law enacted in May 2006 stipulates

[*1] http://www.jcgf.org/en/revised-principle.html

employees' compliance to the law and the articles of incorporation as one of the components of a basic framework for internal control that should be implemented by large companies. One argument in debate on corporate governance places employees outside the true scope of corporate governance, but based when assuming the provisions in the Company Law, the role of employees cannot be overlooked for realizing fair and efficient management.

With deregulation and downsizing of public institutions going forward, private enterprises and especially publicly-held joint stock corporations are growing in importance in the Japanese economy. Moreover, as international investment spreads, there have been strong demands to establish highly transparent rules of conduct for company management in Japan. The Organization for Economic Co-operation and Development (OECD) made up of 30 developed countries also revised its own corporate governance principles in 2004, showing that these changes are occurring worldwide.

Based on these changes, the Forum has decided to revise the Corporate Governance Principles that have been drawn up twice in the past, and it is needless to say that the above ideals of the 2001 revised guidelines will also be carried over to the greatest extent possible. These Corporate Governance Principles maintain the foundations incorporated in the principles revised in 2001 such as the "Mission and Role of the Board of Directors' and "Reporting to the Shareholders and Communicating with Investors", while also incorporating new aspects such as CSR, internal control, auditing of accounts and the role of employees in establishing corporate governance to contribute to the future advancement of the joint stock corporation system. However, it must be noted that these principles do not take the stance that the measures shown below for improving corporate governance are absolutes. This is because methods for improving corporate governance and increasing its effectiveness can never be considered to be complete. Therefore, the specific measures shown in these principles are those considered to be best at the present time and it will be necessary to make the appropriate revisions as necessary based on theoretical and practical developments.

These principles have been prepared using the following terminology.

- Company officer This refers to directors, statutory auditors and executive officers.
- Operating officer The term "executive manager" was used in the 2001 revised principles, but here this refers to representative directors, executive directors, executive officers and CEOs (i.e. chief executive officers and presidents).
- Large companies This basically refers to large publicly-held companies, but may also include companies with a small number of shareholders if they have many stakeholders.
- Independence As stated in Principle 4-2 of the previously revised version, this refers to a person who "does not hold any interest with respect to the company." See Principle

4-2 of the 2001 revised principles for details.

1 General Rules

1.1 Corporate Governance

- **Corporate governance is a mechanism to ensure company officers entrusted with responsibilities by shareholders fulfill the entrusted responsibilities.**

The companies envisaged in these principles are large companies, in which it is assumed that shareholders do not handle management themselves, but instead much of management is entrusted to operating officers and carried out by operating officers in accordance with the duty of care of a good manager, the duty of loyalty and the "principle of executive decision-making." Here, entrusted responsibilities mean a company officer carrying out duties for the purpose of increasing long-term shareholder profits.

If this is amplified, in companies with a board of auditors, a company officer that is a director is required to contribute to long-term shareholder profit by participating in decisions on the execution of company operations as a member of the Board of Directors, while also performing supervisory functions of the Board of Directors over other operating officers. Directors that are also representative directors or other executive directors must make arbitrary decisions about day-to-day business and carry out the decisions of the Board of Directors and the general shareholders' meeting with the aim of improving long-term shareholder profits. Moreover, auditors perform their prescribed function as checks on management by auditing the execution of business by the Board of Directors as independent bodies or through the board of auditors.

In contrast, in companies with committees, directors appointed by the general shareholders' meeting are required to perform their duties of supervision as a member of the board of directors, which supervises operating officers. In particular, outside directors are expected to supervise the execution of operations by executive officers from the perspective of improving long-term shareholder profits through the exercising of voting rights in the board and through the nomination committee, the audit committee and the compensation committee. Executive officers must execute operations of the company including the authority granted to them by the Board of Directors with the aim of improving long-term shareholder profits.

Corporate governance not only includes the aspect of ensuring company officers' entrusted responsibilities in normal situations, but also includes the aspect of preparing in advance for abnormal situations that are situations in which potential conflicts of interest for the company materialize.

1.1.1 Corporate Governance and CSR

- **CSR refers to business activities being conducted in accordance with the law and social norms with the awareness that the company is both a trading entity in the market and a member of society at the same time.**

A company is both a trading entity in the market and a member of society, and not only has an economic impact on society, but is also subject to social norms and social restrictions. Because of this, CSR is required of a company by society when conducting business. However this does not mean recognizing the use of CSR as a substitute for corporate governance. Here, CSR not only refers to contributing part of the profits obtained as a result of business activities, but also to observing laws and social norms in the process of conducting business activities.

1.1.2 CSR and Stakeholders

- **CSR means that a company should conduct sustained business activities with the primary goal of increasing long-term shareholder profits while also building cooperative relationships by giving consideration to the interests of other stakeholders.**

A company has relationships with a diverse range of stakeholders. These include not only shareholders and investors, but also creditors, employees, consumers, clients, governments and regional communities. Therefore, a company is required to conduct sustained business activities primarily aimed at increasing long-term shareholder profits while also building cooperative relationships by giving consideration to the interests of other stakeholders. In this respect, CSR is an important issue in management. Needless to say, CSR means it is not acceptable for an operating officer to utilize company resources for personal gain or interest or to behave with disregard to shareholders under the pretense of this being "for society".

1.2 Purpose of the Company

- **As the large companies covered by these principles are basically required to be going concerns, the purpose of the company is to increase long-term shareholder profits.**

Here, long-term shareholder profits include financial assets, intangible assets, prestige and relationships with other stakeholders generated in business activities. Because of this, in-

creasing long-term shareholder profits is not inconsistent with increasing stakeholders' profits, and is actually achieved by giving consideration to all stakeholders. However, when conflicts actually occur between long-term shareholder profits and the interests of other stakeholders, the former is given preference.

1.3 Position of the Principles

- **These principles indicate what the Forum believes to be best practices regarding corporate governance and call for their adoption by the companies covered.**

The principles do not call for revisions to the current legal system, but are positioned as showing a better direction and a universal framework required for companies to establish corporate governance within the framework of the current legal system.

- **If for some reason, a company that has adopted the principles deems that adopting measures that differ in part from the content of the principles will bring about a desirable effect in the realization of the company's goal of increasing long-term shareholder profits, the company may adopt the different measures after showing the reasoning for the move through an opportunity to indicate its own approach to corporate governance.**

Examples of "an opportunity to indicate its own approach to corporate governance" include materials for general shareholders' meetings and business reports that are the disclosure documents stipulated in the Company Law, documents such as securities reports, semiannual reports, and internal control reports stipulated in the Financial Products Exchange Law, reports on corporate governance required by the Stock Exchanges and abbreviated financial statements announced following the end of the fiscal year.

2 Detailed Rules

2.1 Shareholders and the General Shareholders' Meeting

2.1.1 Operation of the General Shareholders' Meeting

- **In addition to its function as a decision-making organ for forming a consensus among shareholders, the general shareholders' meeting is also effectively utilized as a stage for dialogue between shareholders and management.**

The general shareholders' meeting is positioned as the highest decision-making organ of a company in the Company Law, and is the cornerstone of corporate governance making decisions for the company regarding the appointment and dismissal of company officers, etc. (except executive officers in companies with committees) and on fundamental matters regarding the company. There is no doubt that the ordinary general shareholders' meeting is important not only as a place for reporting on the company's accounts and reporting on its businesses, but also as a place for dialogue between the directors and executive officers entrusted with the company's management, statutory auditors that act as auditing organs, and shareholders. From this perspective, attention must be given to the following points regarding the convocation and operation of general shareholders' meetings.

First, the date and location of the general shareholders' meeting must be set to ensure attendance by the greatest number of shareholders possible. The purpose of the date is to ensure shareholders have the opportunity to attend by avoiding concentrations of ordinary general shareholders' meetings of companies closing their books in March as was previously seen in Japan. The Company Law does not include any provisions limiting the location to the location of the company headquarters or an adjacent region unless otherwise stipulated in the articles of incorporation, enabling free choice, but arrangements must not make it difficult for shareholders to attend the general shareholders' meetings.

Second, considering the general shareholders' meeting's purpose as a place for forming shareholder consensus, convocation notices and related information must be sent to shareholders as far in advance of the statutory deadline as possible. The qualifications for the proxy exercise of the voting rights of shareholders are not restricted.

Third, under the Company Law, a company may set the deadline for voting in writing or electronically to be a date before the general shareholders' meeting on the condition that there is an interval of 2 weeks from the time the convocation notice is sent, but the deadline must be within 48 hours from the time the general shareholders' meeting is held.

Fourth, the companies covered by these principles are basically envisaged to be companies with accounting auditors, and as a special rule for such companies, the Company Law allows approval of accounting documents at the ordinary general shareholders' meeting to be replaced by approval by the board of directors when certain conditions are met, in addition to recognizing the distribution of surplus funds only with a resolution by the board of directors when certain conditions are met. As a result, the ordinary general shareholders' meeting is mainly a place for the appointment of directors and statutory auditors, meaning that the general shareholders' meeting mainly functions as a place for gauging the confidence of shareholders in company officers. Considering such functions of the general shareholders' meeting, the scope of explanations given by directors, statutory auditors and executive officers in response to questions from shareholders is not limited to agenda items and reported items shown in the convocation notice, but extends to all matters related to the company that are deemed to reasonably considered as being of general interest to shareholders including management policy.

2.1.2 Voting by Major Shareholders and Institutional Shareholders

- **Major shareholders and institutional shareholders (institutional investors) should exercise their voting rights appropriately.**

Major shareholders and institutional shareholders should exercise their voting rights appropriately by giving consideration to the matters put before the general shareholders' meeting, in addition to giving sufficient consideration to the company's objective of increasing long-term shareholder profit. In particular, institutional investors have been entrusted with the duty of achieving the best profits for trust investors and beneficiaries、 pension beneficiaries and insurance policyholders, and exercising voting rights for shares under management is part of performing entrusted duties. The state of shareholder rights and especially voting by institutional shareholders is extremely important as the interests of stakeholders in large companies are reflected in the company's management if institutional investors fulfill their entrusted duties by exercising voting rights. Meanwhile, as the voting rights held by major shareholders and institutional shareholders often have an impact on company management due to their size, attention must be given to ensure that the exercise of shareholders' rights typified by voting rights do not cause conflicts of interest with other general shareholders, etc. consider the objective of increasing long-term shareholder profit of shareholders of the company as a going concern.

2.2 Board of Directors

- **The board of directors should appropriately perform the desired functions as an organ for carrying out decision-making on company operations and overseeing the bodies conducting business. The steps required to implement such functions should be carried out with regard to the composition and operation of the board of directors, together with the division of authority among the board of directors, the representative director and other executive directors or executive officers.**

For both a company with a board of directors and a company with a board of auditors, the board of directors of a large company is an organ that makes certain decisions regarding company operations while also overseeing the performance of duties by operating officers.

From this perspective, first, the board of directors periodically evaluates the performance of operating officers based on the basic management policy it has created, dismissing operating officers and taking other prescribed steps as required. Therefore, the directors that are members of the board of directors must have an accurate awareness of their duties and take the greatest care and do their best to appropriately fulfill their duties regardless of whether they are executive directors, executive officers concurrently acting as directors or outside directors.

Second, as the board of directors must be able to effectively execute their authority of overseeing operating officers, supervision and execution must be separated. Therefore, even directors other than outside directors are not permitted to concurrently serve as employees not only in companies with committees for which the law does not permit directors also serving as employees, but also in companies with a board of auditors, which are not subject to any legal restrictions. The majority of the members of the board of directors in a company with committees is made up of independent outside directors. The board of directors in companies with a board of auditors is not legally required to have outside directors, but it is preferable for at least two independent outside directors to be included to ensure the supervisory functions over the board of directors.

Third, both companies with committees and companies with a board of auditors should generally separate the functions of the chairman of the board of directors from those of the president and the CEO. One way of achieving this is for an independent outside director to be appointed as the chairman of the board of directors, but a past president may act as the chairman of the board of directors as an exception on the condition that there is an effective division of duties such as the chairman of the board not being directly involved in the execution of operations. At any rate, the president, other executive directors or executive

officers concurrently acting as directors should not concurrently hold the position of chairman. As the chairman of the board of directors is in charge of the agenda of meetings of the board of directors and has influence over the operation and state of the board of directors, separating the representative director and president who is the operating officer subject to supervision by the board of directors from the chairman of the board of directors should contribute to the supervisory functions of the board of directors. In addition to companies with committees, the appointment of outside directors is also conceivable in other companies, but from the perspective of outside directors' check and balance functions over operating officers, the chairman in charge of the board of directors should be a person that can work with outside directors to supervise operating officers instead of being a person subject to supervision by outside directors.

Fourth, written resolutions in the board of directors and reporting may be omitted on the condition that certain requirements in the Company Law are met, but this measure is only treated as an exception and meetings of the board of directors are generally held periodically.

Fifth, even a company with a board of auditors should establish a compensation committee, a nomination committee and other committees that are arbitrary institutions, and the members should generally be chosen from among directors by board resolution. However, external experts independent from operating officers may be appointed as committee members if necessity dictates. The compensation committee should be made up of no less than three members and a majority should be outside directors. The compensation committee carries out the distribution of director compensation as determined by the articles of incorporation or resolution of the general shareholders' meeting, also taking into account assessments of the performance of the board of directors. Incidentally, in actual practice, it is not rare that executive officer systems are used in companies with a board of auditors and executive officers are nominated. Compensation for executive officers is not subject to the officer compensation system under the Company Law, but it is preferable that the compensation committee is involved in determining compensation for executive officers.

The nomination committee should be made up of no less than three members and a majority should be outside directors. A majority of the member of the nomination committee should be directors other than executive directors, and is responsible for drafting motions for appointing directors and for the board of directors regarding the appointment and dismissal of operating officers. The board of directors makes decisions on proposals for the appointment of directors on the appointment and dismissal of operating officers based on drafts prepared by the nomination committee.

2.3 Outside Directors

- **Outside directors should not be limited to meeting the requirements stipulated in the Company Law for the people playing the principal role in the function of the supervision of the board of directors, but also be effectively independent. A company should appoint multiple outside directors. Outside directors should periodically hold meetings only made up of outside directors. On that basis, outside directors should fulfill their supervisory responsibilities by voting in board meetings and providing shrewd suggestions on not only legality, but also a wide variety of perspectives including appropriateness and effectiveness.**

According to the Company Law, outside directors are expected to have supervisory functions over the operating officers in the board of directors and play an important role in ensuring fair decisions are made by the board of directors not only in companies with committees that are required to appoint outside directors, but also in other companies that appoint outside directors voluntarily. Because of this, first, although the board of directors of a company with a board of auditors is not legally required to have outside directors, at least two independent outside directors should be included to guarantee the supervisory functions of the board of directors. The majority of the board of directors of a company with committees is made up of independent outside directors.

Second, outside directors not only need to meet the requirements for outside directors stipulated by the Company Law, but also have effective independence[*2] suited to their roles. Therefore, directors and employees of parent companies or major clients should not be outside directors in subsidiaries and especially listed subsidiaries, the mutual dispatch of directors should be avoided and the term of outside directors should not exceed 5 years.

Third, outside directors should hold discussions in periodic meetings only made up of outside directors (hereinafter referred to as the outside directors' council) as a place for ensuring cooperation and for sharing and updating understanding and awareness about company management. A head outside director is selected in the outside directors' council, and that director reports the details of discussions in the outside directors' council to the board of directors as required. The outside directors' council may be attended by operating officers or other persons deemed as necessary by the outside directors' council.

[*2] See the Principle 4 of Revised Corporate Governance Principles (October 26, 2001) and the Independent Director Code (October 13, 2005) by the Outside Directors Committee of the Japan Association of Corporate Directors regarding the criteria for determining independence. These principles require outside directors to be effectively independent.

Fourth, outside directors should fulfill their supervisory responsibilities by understanding the operations and goals of the joint-stock corporation, together with the internal and external circumstances surrounding the joint-stock corporation, voting in board meetings and providing shrewd suggestions regarding the execution of operations from a broad range of perspectives including not only their legality, but also their appropriateness and effectiveness.

Fifth, outside directors are expected to fulfill their management supervisory function as members of the board of directors. The reason for the Enforcement Regulations of the Company Law stating that publicly-held companies are an exception and requiring that business reports on outside directors disclose whether an outside director also holds the position of an operating officer in another company, the relationship between the joint-stock corporation and the other company in question and whether an outside director also serves as an outside director in another company is to guarantee the effective functions of the outside director by disclosing to shareholders whether attempts are being made to create an environment suitable for the performance of duties by the outside director in question. Therefore, outside directors themselves are required to make an effort to secure sufficient time for carrying out their duties, and to refrain from taking positions that inhibit their effectiveness.

2.4 Statutory Auditors, Board of Auditors and Audit Committee

- **Statutory auditors, the board of auditors and the audit committee should prepare audit policies for appropriately carrying out their duties, conduct audits of the performance of the duties of directors and executive officers based on these, and pay attention to preparing an environment for carrying out duties as statutory auditors and audit committee members.**

First, the operational audits conducted by statutory auditors, the board of auditors and the audit committee are to be conducted by incorporating the perspective of whether the operations of the company are consistent with the company's goals and basic philosophy.

Second, as the independence of statutory auditors and audit committee members is a condition for ensuring the duties of statutory auditors, the board of auditors and the audit committee are carried out appropriately, they play an active role in selecting candidates for new statutory auditors and audit committee members, in addition to the determination of compensation for statutory auditors and audit committee members.

Third, at least one statutory auditor and audit committee member should have considerable understanding and knowledge of accounting, or work to acquire this.

Fourth, in accordance with the law, employees are only engaged to assist the performance

of duties of statutory auditors if there has been a request from the statutory auditor, but the board of directors should establish audit operations assistants such as a statutory auditor's office made up of staff independent from operating officers unless there has been a separate statement of intent from a statutory auditor. The statutory auditor's operational assistants should be employed full time in that position only whenever possible, and the appointment shall be made by the board of directors after consulting with the statutory auditors.

Fifth, statutory auditors and the audit committee should work with statutory auditors and audit committee members in group companies and take the steps such as introducing a group audit council required to ensure that the execution of operations of the group as a whole are in compliance with the law, the articles of incorporation and other related regulations.

2.5 Compensation for Company Officers

- **The details of compensation for company officers are determined by the company in accordance with the Company Law, and should correspond to the performance and duties of the company officers, and be reasonable consideration of the execution of duties of company officers. Compensation in the form of stock options shall not be granted to statutory auditors, audit committee members or outside directors. The company should individually disclose and take other steps required to increase the transparency of compensation for company officers.**

As the Company Law provides the procedures and requirements for determining the compensation of company officers, these provisions must naturally be adhered. Necessary steps must also be taken to ensure that this is reasonable consideration for performance and the duties carried out. From this perspective, even companies with a board of auditors, for which there is no system for the establishment of compensation committees, should establish a compensation committee made up of at least three members, a majority of whom are outside directors. This committee considers the performance and the duties carried out by directors and distributes compensation for directors that is included in the compensation of company officers stipulated by the articles of incorporation or resolution by the general shareholders' meeting. In contrast, for compensation for statutory auditors, if the total or maximum amount for all statutory auditors is determined by the articles of incorporation or a resolution passed by the general shareholders' meeting, the compensation of each statutory auditor is determined through consultations with statutory auditors in accordance with the Company Law in order to maintain the independence of statutory auditors.

Second, the compensation policy should require that the compensation of company officers

is linked to the duties performed by the company officers who are the recipients of the compensation, and must not impede the independence of statutory auditors or the audit committee. Therefore, the compensation of directors of companies with a board of auditors and of executive officers of companies with committees should not be limited to fixed amounts and may include compensation linked to company performance in the form of stock options, etc. The company should design the details of this as reasonable incentive compensation taking into consideration the performance and the duties performed by the director or executive officer in question. In contrast, statutory auditors, audit committee members and outside directors should not be granted performance-linked compensation such as stock options. Third, the policy for determining compensation and the specific details of compensation for company officers should be disclosed in the business report by breaking down the details into categories according to the type of compensation and providing an explanation on the duties performed by each person and performance during the period covered by the compensation.

2.6 Corporate Governance and the Role of Employees

- **Shareholders and company officers must be aware that management of a joint-stock corporation is also collaboration with its employees. Employees should contribute to increasing the value of the company by having a shared awareness with shareholders and company officers about the company's business goals, management policies, management philosophy and management targets.**

Although there are some exceptions, management of a large joint-stock corporation cannot be conducted by company officers alone, and is carried out with the cooperation of employees that have the appropriate skills and experience. Therefore, the contributions of shareholders, company officers and employees who play a part in the company's operations are required for the improvement of corporate governance. First, company officers are required to take steps to share awareness about business goals, management policies, management philosophy and management targets through dialogue with employees and disclosure of information to employees.

Second, based on the necessity and importance of the contribution and cooperation of employees for the improvement of corporate governance, it is necessary for employees themselves to be clearly aware of the role they play, and they should present issues and provide suggestions aimed at actively improving company management. In order to achieve this, company officers and particularly operating officers should take responsibility in the creation of an environment and framework enabling the facilitation of communication between company officers

and employees within the company.

Third, as employees' illegal behavior, irregular behavior and inappropriate responses in the current phase of company management may endanger the continuation of the company's business, employees must be aware of the potential that their actions or inaction may determine the fate of the company and necessity and importance of acting in accordance with the law and articles of incorporation and of complying with the company's management policy and management philosophy in the performance of their duties. Furthermore, when an employee discovers misconduct or matters in violation of the law or articles of incorporation within their department, the information should be conveyed to the person responsible without delay by using a helpline or internal reporting system.

Fourth, company officers and especially operating officers should work toward encouraging employees to have compliance awareness and understanding of the company's management policies and management philosophy through dialogue with employees, the disclosure of information and the establishment of a Code of Conduct, in addition to creating internal reporting systems. Furthermore, evaluations of compliance and corporate ethics should be included in personnel evaluations as a means for making such moves more effective.

2.7 Internal Control

2.7.1 Establishment of a System of Internal Control and Ensuring its Effectiveness

- **A company's board of directors should create systems for ensuring the performance of duties by directors and executive officers is in compliance with the law and the articles of incorporation and that other company operations are appropriate, in addition to ensure financial reporting is conducted in an appropriate and timely fashion in accordance with the Company Law directives from the Ministry of Justice, Financial Products Exchange Law and directives from the Cabinet Office, and is responsible for ensuring these systems function effectively.**

A company's board of directors should appropriately create systems for ensuring the performance of duties by directors and executive officers including risk management of the company and the group to which it belongs is in compliance with the law and the articles of incorporation and that other company operations are appropriate, in addition to ensure financial reporting is conducted in an appropriate and timely fashion in accordance with the Company Law and other related laws and is responsible for ensuring these systems function effectively.

In order to do this, first, the board of directors should appoint one or more directors as directors responsible for internal control, and periodically monitor the effectiveness of internal

control through these directors.

Second, the board of directors should create a system in which operating divisions provide periodic and exhaustive reports in an attempt to secure and facilitate the conveyance of information in the internal control system. The internal reporting system shall be incorporated into the internal control system as part of its reporting system, and reports shall be made to the bodies conducting business and must also be made to either the board of auditors or the audit committee.

Third, auditors and the board of auditors or the audit committee should directly audit the effectiveness of the internal control system as part of their auditing duties, and include this evaluation in their audit reports. The internal control system includes a mechanism for directly conveying all relevant information to the board of auditors or the audit committee.

2.7.2 Operation of the Internal Control System

- **Key operating officers such as the CEO should take a leading role in the prevention of corporate scandals, and be held accountable for the handling of such scandals.**

The companies covered by these principles are generally required to create an internal control system (Company Law Article 348-3(4) and -4, Article 362-4(6) and -5, Article 416-1(1)b and e). Key operating officers such as the CEO should implement the framework for the internal control system stipulated by a resolution of the board of directors, and be responsible for making it function. As part of this, keeping employees, etc. informed about compliance approaches is included in taking a leading role in the prevention of scandals.

2.8 Disclosure

- **A company is required to disclose accurate information on its financial situation, management performance, shareholder composition, systems for effecting corporate governance, risk factors and negative information such as scandals using an appropriate method at the appropriate time.**

Shareholders entrust the management of the company to operating officers. Company officers entrusted with responsibility have the obligation to prove they are fulfilling their responsibilities. This is accountability, and disclosure is an important means for carrying it out.

The disclosure of company information is essential for ensuring fair price formation of marketable securities the company issues. Through trading, the stock market determines the price

of marketable securities issued by the company. Put differently, it has the function of identifying the appropriate value of the company. To ensure that this functions properly, the scope of disclosure should extend to all information contributing to accurate decisions on aspects such as the current state of management and future risks, and should not be limited to the scope stipulated by the law.

Disclosure is extremely important not only for shareholders, but all stakeholders such as creditors and clients in decisions on matters such as whether to continue or terminate business and the exercising of rights. As famously stated by US Justice Brandeis, "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman,"[*3] this also leads to the prevention of fraudulent behavior by the company.

It is not mandatory to disclose information such as advanced management strategies that should not be released in order to ensure the company stays competitive, but this must not be an excuse for company officers to protect themselves by concealing scandals or deteriorating performance.

- **The disclosure of company information must not be limited to the company as a single entity, but instead include the entire corporate group to which the company's influence extends, such as subsidiaries.**

The scope of consolidation is already becoming an actual standard due to reform to the accounting system. Moreover, the lifting of the ban on simple holding companies and introduction of a corporate divestiture system have further increased the importance of viewing companies as corporate groups including subsidiaries and affiliates since the 1990s. Information needs to be disclosed based on this. Active disclosure of investment funds, etc. effectively under the control of the company is also required.

As the safeguarding of the rights of minority shareholders is extremely important for listed subsidiaries, disclosure of information such as transactions with the parent company and the level of influence on management achieved by dispatching a CEO, etc. is required.

- **The announcement of a company's CSR activities is also preferable in the form of documents such as environmental reports, sustainability reports and CSR reports. Disclosing the state of efficient and fair activities to shareholders, employees, consumers and regional communities leads to an increase in company value.**

[*3] Brandeis, Louis D. 'Chapter V: What Publicity Can Do',' "Other People's Money", Harper's Weekly, Dec. 20, 1913

In recent years, companies have become aware of corporate social responsibility, and its implementation has come to be required. Environmental reports are principally issued toward investors who are shareholders or potential shareholders, but they should also be made available to other stakeholders. Deepening the understanding of stakeholders and obtaining their support makes a company more competitive by expanding the consumer base of products and services and increasing the morale of employees.

2.9 Audits of Accounts

2.9.1 Ensuring the Independence of Accounting Auditors

- **To ensure the accounting auditor of a company carries out its duties appropriately, a company should take the steps required to ensure the independence of the accounting auditor from a company with an accounting auditor and its operating officers.**

To ensure the accounting auditor of a company carries out its duties appropriately, a company must take steps to ensure cooperation between the accounting auditor and statutory auditors or the audit committee, while also guaranteeing the independence of the accounting auditor. As part of this, first, a company should replace the certified public accountant or audit firm used as the accounting auditor if the term of engagement exceeds a certain number of years (7 or 5), and engage a different certified public accountant or audit firm as the accounting auditor[*4]. However, obligatory replacement of the accounting auditor is limited to audit firms able to provide account auditing operations to companies that have international operations, and this has been indicated as potentially leading to the position simply being passed around among major accounting firms that effectively enjoy an oligopoly. It is a fact that many are strongly opposed to this in Japan and debate about its validity continues in the United States for reasons such as the reduction of auditing capabilities caused by the replacement, the decline in urgency near the end of an audit firm's term and the difficulties faced by new audit firms unfamiliar with the audited company in the handling of audits on internal control. However, considering the importance of the auditing of accounts, the establishment of appropriate terms for the replacement of accounting auditors eliminates the development of cozy relationships with management, and has the significant benefit of examining the company's problems from a new perspective. It is assumed that the board of directors is independent from the audit

[*4] According to the Company Law, if an audit firm is appointed as the accounting auditor, the person for performing duties of the accounting auditor is chosen from among the firm's employees (Company Law Article 337-2), and replacement of the accounting auditor refers to replacing the audit firm with another audit form, and does not simply refer to the employee performing duties of the accounting auditor being replaced without the audit firm appointed as the accounting auditor being replaced.

committee and board of auditors, providing appropriate supervision and guidance over the accounting auditor.

Second, companies with accounting auditors are not generally permitted to receive non-audit services in the company or its relations with its parent company or subsidiaries from the certified public accountant or audit firm engaged as the company's accounting auditor. In cases where non-audit services are received in addition to accounting audit services, the certified public accountant or audit firm must take steps to ensure the independence of the audit personnel.

2.9.2 Compensation for Accounting Auditors

- **The details of compensation for accounting auditors are determined by the company in accordance with the Company Law, and should correspond to the duties of the accounting auditors, and not hinder the independence of the accounting auditors. Accounting auditors should not be granted performance-linked compensation such as stock options. When the company pays consideration to the accounting auditor for non-audit services, the details of the non-audit services should be disclosed and the part of consideration for audit services should be distinguished from the part of consideration for non-audit services.**

As the Company Law provides the procedures and requirements for determining the compensation of accounting auditors, these provisions must naturally be adhered to when determining the compensation of the company's accounting auditors. Necessary steps must also be taken to ensure that this is reasonable consideration for the duties carried out by the accounting auditors and these must not impede the independence of the accounting auditors. Therefore, the company's accounting auditors should not be granted performance-linked compensation such as stock options.

When the company pays consideration to the accounting auditor for services other than auditing (non-audit services), the details of the non-audit services should be disclosed in the business report (Article 126-3 of the Enforcement Regulations of the Company Law), and the part of consideration for audit services should be distinguished from the part of consideration for non-audit services in disclosure of the compensation of the accounting auditors.

If the replacement of accounting auditors is made mandatory, a shift to a standard compensation format based on factors such as the size of the company is conceivable of compensation for accounting auditors, and even in such cases, the final value of compensation is determined according to the details of the services provided each year.

3 Handling of "Abnormal Situations (When a Conflict of Interest has Materialized)"

3.1 Response to Deterioration of Performance

- **A key operating officer such as the CEO should reveal the reason for the decline or deterioration of performance, indicate the steps that will be taken, and take responsibility for the implementation of these. The CEO is responsible for explaining the reason for the deterioration in performance and the policy in dealing with the matter to stakeholders such as shareholders. Outside directors, etc. should evaluate the performance of operating officers based on the explanation by the CEO.**

3.2 Response to Hostile Takeover Bids

- **A place should be established to ensure judgments on bids to acquire the company are made from a viewpoint independent from operating officers based on the perspective of the company's objective of increasing long-term shareholder profits.**

Operating officers can have a conflict of interest with bids to acquire the company. Therefore, the effective decision of whether the bid will increase the long-term shareholder profits must be made by an independent external auditor or a person with a view from outside the company who is not an operating officer.

- **Defense measures against takeover bids should be designed to ensure they do not hinder bids that are aimed at increasing the long-term shareholder profits. Full explanations must be given to shareholders when introducing defense measures.**

Sufficient explanations on the details and expected effect of takeover defense measures must be given to shareholders when they are being introduced. By providing the company with measures for defending against takeover bids that clearly violate long-term shareholder profits and with opportunities to present alterative proposals for increasing the value of the company, takeover defense measures provide shareholders who are the ultimate decision-makers with information required for making decisions and ensuring that they have time to consider the matter.

The intent of shareholders must be respected when implementing takeover prevention measures, but obtaining approval from the general shareholders' meeting is not required. The first reason is that the implementation of takeover defense measures is not necessarily a matter falling under the authority of the general shareholders' meeting when looking from the perspective of the division of authority between the general shareholders' meeting and the board of directors. The second is that there is a risk that requiring approval from the general shareholders' meeting for implementing takeover defense measures could give operating officers a free hand based on the excuse of having approval from the general shareholders' meeting.

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