Roles Expected of Outside Directors and Boards of Directors

Preamble

Corporate governance at listed companies in Japan is about to face a major turning point. In line with a growing trend among listed companies towards appointing outside directors, focus has once again intensified on the roles expected of outside directors. Clarity is urgently needed in these roles to ensure that newly appointed outside directors fulfill their responsibilities appropriately.

However, there are many different views about the roles expected of outside directors, and there also seems to be some misunderstanding about the fundamental elements of these roles. This misunderstanding may be preventing management from appointing or increasing the number of outside directors.

The purpose of this proposal is to present the views of the Japan Association of Corporate Directors (JACD) on the roles expected of outside directors and their core responsibilities.

In this proposal, JACD has identified the main responsibility of outside directors to be provision of oversight on management. Based on this understanding, the proposal will clarify what is at the core of each outside director's oversight function and the roles that should, or should not, be expected of outside directors.

A large portion of the views presented in this proposal shares many similarities with the Monitoring Model, which is a model for boards of directors adopted widely all over the world and that focuses on oversight on management. For most members of management who conduct business in good faith, the views presented in this proposal, and the Monitoring Model, are meant to support, and not hinder, their business management.

While the views presented in this proposal apply to all listed companies, the main focus is placed on companies with statutory auditors (*kansayaku*) that are facing an urgent need to clarify the roles expected of outside directors.

JACD hopes that a more precise understanding of roles and responsibilities expected of outside directors will result in an increase in the appointment of outside directors in Japan, as well as an increase in the trust placed in boards of directors by shareholders, which will ultimately increase corporate value.

Proposal

1. **The main responsibility of outside directors and boards of directors is to provide oversight on management (executives) rather than making business (executive) decisions.**

2. **The core of the oversight function is to examine whether management's performance, in light of business strategies and plans developed by management, is appropriate and to ultimately determine whether or not to entrust business to the incumbent management.**

3. **Specific roles are:**
   (i) Requesting management to provide explanations on business strategies and plans,
   (ii) Examining if those business strategies and plans are acceptable from the standpoint of shareholders,
   (iii) Requesting management to provide explanations about management outcomes, and
   (iv) Evaluating management based on the above and determining whether to entrust business to the incumbent management.

   Put differently from the perspective of the management's responsibility, management is responsible for explaining to, and convincing, boards of directors that include outside directors that the business strategies and plans are legitimate and that performance of those strategies and plans is appropriate.

4. **In addition to the above, outside directors are expected to provide oversight on management from the following perspectives: enhancing the reliability of financial information that forms an important basis for evaluation of management and investment decisions by investors; maintaining management compensation at an appropriate level in proportion to their performance; preventing management from committing acts that constitute a conflict of interest; and developing an effective risk management framework.**

5. **Oversight on management does not mean that outside directors and boards of directors conduct management. When a board of directors makes**

2

decisions on the execution of important operations as required under the Companies Act, outside directors should determine whether the proposals by management are acceptable from the standpoint of shareholders. In this sense, such decisions have a nature similar to oversight. Compared to management, outside directors, as outsiders, tend to lack special knowledge or information regarding business operations. Therefore, the responsibility of outside directors is not to make decisions on individual business operations, but rather to leverage their expertise in evaluating management and the entire business in order to increase corporate value.

6. **The board of directors should fully deliberate matters that are appropriate for oversight by outside directors. At the same time, decisions on individual business operations should be delegated to management to the extent permitted under laws and regulations, except when a conflict of interest exists between management and the company.**

7. **Oversight on management does not mean that outside directors and boards of directors actively take actions to uncover misconduct. While outside directors should provide oversight on the development of a risk management framework to prevent the occurrence of misconduct and should conduct appropriate investigations when finding indications of misconduct in the course of providing oversight, uncovering individual instances of misconduct itself is not the direct purpose of oversight on management by outside directors.**

8. **The independence of outside directors is required in order for them to fulfill the function of oversight on management. Considering that at the core of an outside director's function of oversight on management is the evaluation of management, each outside director's independence from management is indispensable. Independence from management in this sense means that outside directors have no stake in management.**

9. **The number and ratio of outside directors in boards of directors need to be increased to enhance outside directors' function of oversight on management. Granting important roles and authority to a large number of outside directors, rather than a small number, will increase the quality of oversight,**

3

which will in turn contribute to increasing oversight stability.

10. **It is desirable that many and diverse outside directors are appointed. However, considering that at its core, each outside director's function of oversight is the evaluation of management, it is reasonable to give first priority to retaining outside directors who are suited to fulfilling that core element, e.g., those who have knowledge about business management in general, such as persons who are current or former members of management in other companies.**

11. **A large portion of the views provided in this proposal shares many similarities with the Monitoring Model. The Monitoring Model offers a framework for boards of directors that identifies the basic role expected of boards of directors that include outside directors as being the provision of oversight on business operations, including the appointment and dismissal of executives, rather than the making of decisions on business operations. Since its birth in the United States in the 1970s, the model has been widely adopted by a large number of listed companies in the United States and is gaining popularity in other countries. For most members of management who conduct business in good faith, the Monitoring Model serves as a framework for receiving support for their management from shareholders through outside directors, as opposed to hindering management. The model is an effective tool for enhancing the legitimacy of management and to support management.**

12. **There is a wide range of options available when determining the responsibilities of outside directors and models for boards of directors. In addition, these can vary from company to company. Even within the Monitoring Model, the main focus of oversight can vary and models for boards of directors are not limited to the Monitoring Model.**
    Regardless of what choice is made, providing explanations on the characteristics of, or differences from, the Monitoring Model is the key to deepening shareholder and investor understanding of each company's corporate governance.

END

4

Endorsed By:

Takeo Inokuchi, Chairman of Company with an Audit Committee Workshop (*Senior Advisor to CEO*, Mitsui Sumitomo Insurance Co., Ltd.)

Minoru Sawaguchi, co-Chairman of Company with an Audit Committee Workshop (Partner of Mori Hamada & Matsumoto)

Kazuhiko Toyama, Chairman of Committee on Independent Directors. (CEO, Industrial Growth Platform, Inc.)

Seiichi Ochiai, co- Chairman of Committee on Independent Directors. (Professor emeritus, Tokyo University)

About JACD:

Founded on the highest ethical principles, the Japan Association of Corporate Directors (JACD) is a forum for practicing executives to study and experiment with corporate governance. The Association was founded on March 13th, 2002. JACD's 250 members represent corporate executives, institutional investors, lawyers, accountants and university professors. JACD Mission JACD is a group of CEOs and corporate directors whose aim is to encourage Japanese companies to take an active interest in corporate governance and to become more competitive globally through the study of governance and management.

Contact :

http://www.jacd.jp/en/

5